Wage moderation in Germany – at the origin of France's economic difficulties

By *Xavier Ragot, President of the OFCE, CNRS-PSE, together with Mathilde Le Moigne, ENS*

If the future of the euro zone does indeed depend on political cooperation between France and Germany, then economic divergences between the two countries should be a cause for concern. These divergences need to be analysed, with particular attention to three specific areas: the unemployment rate, the trade balance and the public debt. Germany's unemployment rate is falling steadily; in June it was under the 5% mark, which represents almost full employment, whereas the French rate is over 10%. Germany's low unemployment rate does not however reflect strong consumption by German households, but rather the country's export capacity. While France continues to run a negative trade balance (importing more than it exports), Germany is now the world's leading exporter, ahead of China, with a trade surplus that will run close to 8% in 2015. As for the public deficit, it will be around 3.8% in France in 2015, while Germany is now generating a surplus. This has impressive consequences for the way the public debt is changing in the two countries. In 2010 they were similar, at around 80% of GDP, but in 2014 Germany's public debt fell below 75%, and is continuing to decline, while France's debt has continued to grow, and has now hit 97%. This kind of gap is unprecedented in recent times, and is fraught with mounting tension over the conduct of monetary policy.

This triple divergence is inevitably leading to differences in the political response, with respect to the population's ability to take in migrants and to the understanding of countries facing economic difficulties, such as Greece, but also with respect to the ability to cope with future economic crises. Economic divergence will become political divergence. The point is not to idealize the German situation, which is characterized by a large number of workers who have failed to benefit from the fruits of growth, as is shown in a recent study by France Stratégie, as well as by a rapid decline in population. This should not stop us from taking a hard look at the economic gap arising between the two countries.

What are the reasons for Germany's commercial success?

Many factors have been advanced to explain the divergence between the two neighbours: for some, it's a matter of the German strategy – outsourcing value chains, aggressive wage moderation, fostering competition between companies – and for others, French weaknesses: poor geographical and / or sectoral specialization, insufficient public support for exporters, and a lack of competition in certain sectors. Our recent study emphasizes the delayed impact of German wage moderation and suggests that this could explain almost half of the Franco-German divergence. To understand the mechanisms involved, it is necessary to distinguish between the sectors exposed to international competition and the sectors that are sheltered. The exposed sectors include industry, but also agriculture, including animal husbandry, which is currently in the news, and some services that can be traded. The sheltered sector includes transportation, real estate, retailing and a large part of personal services.

While unit labour costs in France have risen regularly and at similar levels in the two above-mentioned sectors, they have remained extraordinarily stable in Germany for nearly ten years. This wage moderation is the result of both poor management of German reunification, which tipped the balance of power during wage negotiations in favour of employers, and, to a much less extent, the introduction of the Hartz reforms in 2003-2005, which aimed to create low-paid work in the less competitive sectors (particularly the sheltered sector). The cost of German reunification is estimated at 900 billion euros, in terms of transfers from former West Germany, or slightly less than three times the Greek debt. Faced with this kind of challenge, the wage moderation initiated in 1993 represented a strategy for re-convergence between the two parts of Germany. In 2012, German nominal wages were 20% lower than French wages in the exposed (tradable) sector and 30% lower in the sheltered sector, compared to the 1993 levels. A look at French and German margin levels shows that in the exposed sector, French exporters have made significant efforts by reducing their margins in order to maintain their price competitiveness. In the sheltered sector, French margins are on average 6% higher than German margins. The bulk of France's loss of price competitiveness is therefore a loss of cost competitiveness.

How much have these differences contributed to unemployment and the trade balance in the two countries? Our quantitative analysis shows that if German wage restraint had not taken place between 1993 and 2012, today's 8% gap in the trade balances would instead be 4.7% (2.2% of this being due solely to German wage moderation in the sheltered sector). Thus, Germany's wage moderation policy explains almost 40% of the difference in trade performance between the two countries. We also found that this wage moderation accounts for more than 2 points of France's unemployment.

The non-price competitiveness gap

This leaves nearly 60% of the difference in the trade balances still needing to be explained. Our study suggests that this difference is due to the quality of the goods produced, so-called non-price competitiveness. Between 1993 and 2012, the German quality-price ratio increased by around 19% compared with that of France, which has therefore more than offset the rise in German export prices relative to French prices. There is clearly a "quality" effect in this non-price competitiveness: Germany produces “high end”, more innovative goods than France does in the same sectors. It is also possible to see an impact due to the outsourcing of some German production (nearly 52% of production volume in 2012) to countries where costs are lower: Germany today is a centre for design and assembly, which saves money on its intermediary costs, enabling it to invest more in brand strategies and efforts to move upscale.

This effect is nevertheless probably endogenous, that is to say, it flows in part from Germany’s advantage in cost competitiveness. Low labour costs have enabled German exporters to maintain their margins in the face of external competition. The funds generated have led to investments which French companies have probably had to forego in order to maintain their price-competitiveness, thus losing the opportunity to catch up with German products in terms of non-price competitiveness over the longer term.

A positive way out and up

The root cause of the gap in economic performance between Germany and France lies in the nominal divergence observed between the two countries since the early 1990s. One way to reduce these differences would be to promote convergence in wages in Europe and in its labour markets more generally. Germany would need to allow wage inflation that was higher than in the periphery countries, thereby dealing with the increase in social inequalities in Germany, while France must not fall into the trap of competitive deflation, which would destroy its domestic demand, while keeping wage movements under control. In this respect, the report of the five Presidents presented by the European Commission on 22 June 2015 proposes the establishment of national competitiveness authorities, which hopefully would allow greater cooperation on social welfare and employment.

The difference in wages between France and Germany has profound implications in terms of economic thought. The increased trade integration that followed the introduction of the euro led not to a convergence but to a divergence in labour markets. It is then up to each State to once again bring about convergence of the economies while supporting economic activity. This State intervention in the economy is more complex than the simple Keynesian framework for the management of aggregate demand, and now involves the convergence of labour markets. Heretofore, Europe's response has been systematic cuts in labour costs, while what is really needed is to increase wages in surplus countries, such as Germany, for example by using the minimum wage as a tool. All this, it is true, is economics. The politics begins when we realize that only long-term cooperation can bring about a convergence in national interests.

Should Germany's surpluses be punished?

By Henri Sterdyniak

On the procedure for macroeconomic imbalances

Since 2012, every year the European Commission analyses the macroeconomic imbalances in Europe: in November, an alert mechanism sets out any imbalances, country by country. Countries with imbalances are then subjected to an in-depth review, leading to recommendations by the European Council based on Commission proposals. With respect to the euro zone countries, if the imbalances are considered excessive, the Member state is subject to a macroeconomic imbalance procedure

(MIP) and must submit a plan for corrective action, which must be approved by the Council.

The alert mechanism is based on a scoreboard with five indicators of external imbalances [1] (current account balance, net international investment position, change in the real effective exchange rate, change in export market shares, change in nominal unit labour costs) and six indicators of internal imbalances (unemployment rate, change in housing prices, public debt, private debt, change in financial sector liabilities, credit flows to the private sector). An alert is issued when an indicator exceeds a certain threshold, *e.g.* 60% of GDP for public debt, 10% for the unemployment rate, -4% (+6% respectively) for a current account deficit (respectively surplus).

On the one hand, this process draws lessons from the rise in imbalances recorded before the crisis. At the time of the Maastricht Treaty, the negotiators were convinced that economic imbalances could only come from the way the State behaved; it therefore sufficed to set limits on government deficits and debt. However, between 1999 and 2007, the euro zone saw a steep rise in imbalances due mainly to private behaviour: financial exuberance, securities and property bubbles, swollen foreign deficits in southern Europe, and a frantic search for competitiveness in Germany. These imbalances became intolerable after the financial crisis, requiring painful adjustments. The MIP is thus designed to prevent such mistakes from happening again.

On the other hand, the analysis and the recommendations are made on a purely national basis. The Commission does not propose a European strategy that would enable the countries to move towards full employment while reabsorbing intra-zone imbalances. It does not take into account inter-country interactions when it demands that each country improve its competitiveness while cutting its deficit. The Commission’s recommendations are a bit like the buzzing of a gadfly when it proclaims that Spain should reduce its unemployment, France should improve its competitiveness, etc. Its proposals are based on a myth: it is possible to implement policies on public deficit and debt reduction, on wage austerity and on private debt reduction, while offsetting their depressive impact on growth and employment through structural reforms, which are the *deus ex machina* of the fable. This year there is also, fortunately, the European Fund for strategic investments (the 315 billion euros of the Juncker plan), meaning that the Commission can claim to be giving "a coordinated boost to investment", but this plan represents at most only 0.6% of GDP over 3 years; its actual magnitude is thus problematic.

For 2015, all the countries in the European Union have at least one imbalance according to the scoreboard [2] (see here). France has lost too much of its export market share and has an excessive public debt and private debt. Germany, too, has lost too much of its export market share, its public debt is excessive and above all its current account surplus is too high. Of the 19 countries in the euro zone, seven, however, have been absolved by the Commission and 12 are subject to an in-depth review, to be published in late February. Let's take a closer look at the German case.

On Germany's surplus

A single currency means that the economic situation and policies of each country can have consequences for its partners. A country that has excessive demand (due to its fiscal policy or to financial exuberance that leads to an excess of private credit) and is experiencing inflation (which can lead to a rise in the ECB's interest rate), thereby widening the euro zone's deficit (which may contribute to a fall in the euro), requires its partners to refinance it more or less automatically (in particular via TARGET2, the system of automatic transfers between the central banks of the euro zone); its debt can thus become a problem.

This leads to two observations:

1. Larger countries can have a more harmful impact on the zone as a whole, but they are also better able to withstand the pressures of the Commission and its partners.

2. The harm has to be real. Thus, a country that has a large public deficit will not harm its partners, on the contrary, if the deficit makes up for a shortfall in its private demand.

Imagine that a euro zone country (say, Germany) set out to boost its competitiveness by freezing its wages or ensuring that they rise much more slowly than labour productivity; it would gain market share, enabling it to boost its growth through its trade balance while reining in domestic demand, to the detriment of its euro zone partners. The partners would see their competitiveness deteriorate, their external deficits widen, and their GDP shrink. They would then have to choose between two strategies: either to imitate Germany, which would plunge Europe into a depression through a lack of demand; or to prop up demand, which would lead to a large external deficit. The more a country manages to hold down its wages, the more it would seem to be a winner. Thus, a country running a surplus could brag about its good economic performance in terms of employment and its public account and trade balances. As it is lending to other member countries, it is in a strong position to impose its choices on Europe. A country that is building up deficits would sooner or later come up against the mistrust of the financial markets, which would impose high interest rates on it; its partners may refuse to lend to it. But there is nothing stopping a country that is accumulating surpluses. With a single currency, it doesn’t have to worry about its currency appreciating; this corrective mechanism is blocked.

Germany can therefore play a dominant role in Europe without having an economic policy that befits this role. The United States played a hegemonic role at the global level while running a large current account deficit that made up for the deficits of the oil-exporting countries and the fast-growing Asian countries, in particular China; it balanced global growth by acting as a “consumer of last resort”. Germany is doing the opposite, which is destabilizing the euro zone. It has automatically become the “lender of last resort”. The fact is that Germany’s build-up of a surplus must also be translated into the build-up of debt; it is therefore unsustainable.

Worse, Germany wants to continue to run a surplus while demanding that the Southern European countries repay their debts. This is a logical impossibility. The countries of Southern Europe cannot repay their debts unless they run a surplus, unless Germany agrees to be repaid by running a deficit, which it is currently refusing to do. This is why it is legitimate for Germany to be subject to an MIP – an MIP that must be binding.

The current situation

In 2014, Germany’s current account surplus represented 7.7% of GDP (or 295 billion euros, Table 1); for the Netherlands the figure was 8.5% of GDP. These countries represent an exception by continuing to run a strong external surplus, while most countries have come much closer to equilibrium compared with the situation in 2007. This is in particular the case of China and Japan. Germany now has the highest current account surplus of any country in the world. Its surplus would be even 1.5 GDP points higher if the euro zone countries (particularly those in Southern Europe) were closer to their potential output. Thanks to Germany and the Netherlands, the euro zone, though facing depression and high unemployment, has run a surplus of 373 billion dollars compared with a deficit of 438 billion for the United States: logically, Europe should be seeking to boost growth not by a depreciation of the euro against the dollar, which would further widen the disparity in trade balances between the euro zone and the United States, but by a strong recovery in domestic demand. If Germany owes its surplus to its competitiveness policy, it is also benefitting from the existence of the single currency, which is allowing it to avoid a surge in its currency or a depreciation in the currency of its European partners. The counterpart of this situation is that Germany has to pay its European partners so that they remain in the euro.

Table 1. Current account balance as % of GDP

	2007	2014
Netherlands	6,7	8,5
Germany	7,5	7,7
Austria	3,5	2,5
Italy	-2,4	1,8
Belgium	1,9	-0,1
Spain	-10,0	-0,1
Portugal	-10,1	-0,2
Finland	4,1	-1,4
France	-1,0	-1,8
Greece	-14,6	-2,0
Euro zone	0,2	2,8
United Kingdom	-2,2	-4,1
Denmark	1,4	6,5
Sweden	9,3	5,9
United States	-5,0	-2,2
Japan	4,9	0,1
China	10,7	3,3

Source : European economy.

There are three possible viewpoints. For optimists, Germany's surplus is not a problem; as the country's population ages, Germans are planning for retirement by accumulating foreign assets, which will be used to fund their retirements. The Germans prefer investing abroad rather than in Germany, which they feel is less profitable. These investments have fuelled international financial speculation (many German financial institutions suffered significant losses during the financial crisis due to adventurous investments on the US markets or the Spanish property market); now they are fuelling European debt. Thus, through the TARGET2 system, Germany's banks have indirectly lent 515 billion euros to other European banks at a virtually zero interest rate. Out of its 300 billion surplus, Germany spends a net balance of only 30 billion on direct investment. Germany needs a more coherent policy, using its current account surpluses to make productive investments in Germany, Europe and worldwide.

Another optimistic view is that the German surplus will decline automatically. The ensuing fall in unemployment would create tensions on the labour market, leading to wage increases that would also be encouraged by the establishment of the minimum wage in January 2015. It is true that in recent years, German growth has been driven more by domestic demand and less by the external balance than prior to the crisis (Table 2): in 2014, GDP grew by 1.2% in Germany (against 0.7% in France and 0.8% for the euro zone), but this pace is insufficient for a solid recovery. The introduction of the minimum wage, despite its limitations (see A minimum wage in Germany: a small step for Europe, a big one for Germany), will lead to a 3% increase in payroll in Germany and for some sectors will reduce the competitiveness gains associated with the use of workers from Eastern Europe. Even so, by 2007 (relative to 1997), Germany had gained 16.3% in competitiveness compared to France (26.1% compared to Spain, Table 3); in 2014, the gain was still 13.5% relative to France (14.7% relative to Spain). A rebalancing is taking place very slowly. And in the medium term, for demographic reasons, the need for growth in Germany is about 0.9 points lower than the need in France.

Table 2. Contributions to GDP by domestic demand and the external balance

	GDP		Domestic demand		External balance	
	1998-2007	2007-2014	1998-2007	2007-2014	1998-2007	2007-2014
Germany	1,60	0,70	0,85	0,70	0,75	0,00
France	2,25	0,30	2,60	0,35	-0,35	-0,05
Spain	3,85	-0,70	4,60	-2,10	-0,75	1,40
Italy	1,50	-1,30	1,65	-2,80	-0,15	1,50
Euro zone	2,30	-0,10	2,20	-0,55	0,10	0,45

Table 3. Indicator of relative unit labour costs

Base 100 = 1997

	2007	2013
Euro zone	99,0	105,2
Germany	86,2	90,4
Austria	94,2	98,1
Finland	98,9	109,3
France	103,0	104,5
Belgium	103,2	107,8
Italy	107,9	111,9
Portugal	110,3	101,8
Netherlands	108,2	111,9
Greece	110,5	98,3
Spain	116,6	106,0
Ireland	124,1	106,1
Outside euro zone		
United Kingdom	122,2	104,1
Sweden	92,4	98,6

Source : European economy.

Furthermore, a more pessimistic view argues that Germany should be subject to a macroeconomic imbalance procedure to get it to carry out a macroeconomic policy that is more favourable to its partners. The German people should benefit more from its excellent productivity. Four points need to be emphasised:

1. In 2014, Germany recorded a public surplus of 0.6 percent of GDP, which corresponds, according to the Commission's

estimates, to a structural surplus of about 1 GDP point, *i.e.* 1.5 points more than the target set by the Fiscal Compact. At the same time, spending on public investment was only 2.2 GDP points (against 2.8 points in the euro zone and 3.9 points in France). The country's public infrastructure is in poor condition. Germany should increase its investment by 1.5 to 2 additional GDP points.

2. Germany has undertaken a programme to reduce public pensions, which has encouraged households to increase their retirement savings. The poverty rate has increased significantly in recent years, reaching 16.1% in 2014 (against 13.7% in France). A programme to revive social protection and improve the prospects for retirement[3] would boost consumption and reduce the savings rate.

3. Germany should restore a growth rate for wages that is in line with growth in labour productivity, and even consider some catch-up. This is not easy to implement in a country where wage developments depend mainly on decentralized collective bargaining. This cannot be based solely on raising the minimum wage, which would distort the wage structure too much.

4. Finally, Germany needs to review its investment policy[4]: Germany should invest in Germany (public and private investment); it should invest in direct productive investment in Europe and significantly reduce its financial investments. This will automatically reduce its unproductive investments that go through TARGET2.

Germany currently has a relatively low rate of investment (19.7% of GDP against 22.1% for France) and a high private sector savings rate (23.4% against 19.5% for France). This should be corrected by raising wages and lowering the savings rate.

As Germany is relatively close to full employment, a significant part of its recovery will benefit its European partners, but this is necessary to rebalance Europe. Any policy suggested by the MIP should require a change in Germany's economic strategy, which it considers to be a success. But European integration requires that each country considers its choice of economic policy and the direction of its growth model while taking into account European interdependencies, with the aim of contributing to balanced growth for the euro zone as a whole. An approach like this would not only benefit the rest of Europe, it would also be beneficial to Germany, which could then choose to reduce inequality and promote consumption and future growth through a programme of investment.

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[1] For more detail, see European Commission (2012) : "Scoreboard for the surveillance of macroeconomic imbalances", *European Economy Occasional Papers* 92.

[2] This partly reflects the fact that some of these indicators are not relevant: almost all European countries are losing market share at the global level; changes in the real effective exchange rate depend on trends in the euro, which the countries do not control; the public and private debt thresholds were set at very low levels; etc.

[3] The ruling coalition has already raised the pensions of mothers and allowed retirement at age 63 for people with lengthy careers, but this is timid compared with previous reforms.

[4] The lack of public and private investment in Germany has been denounced in particular by the economists of the DIW, see for example: "Germany must invest more for future", *DIW Economic Bulletin* 8.2013 and *Die Deutschland Illusion*, Marcel Fratzscher, October 2014.

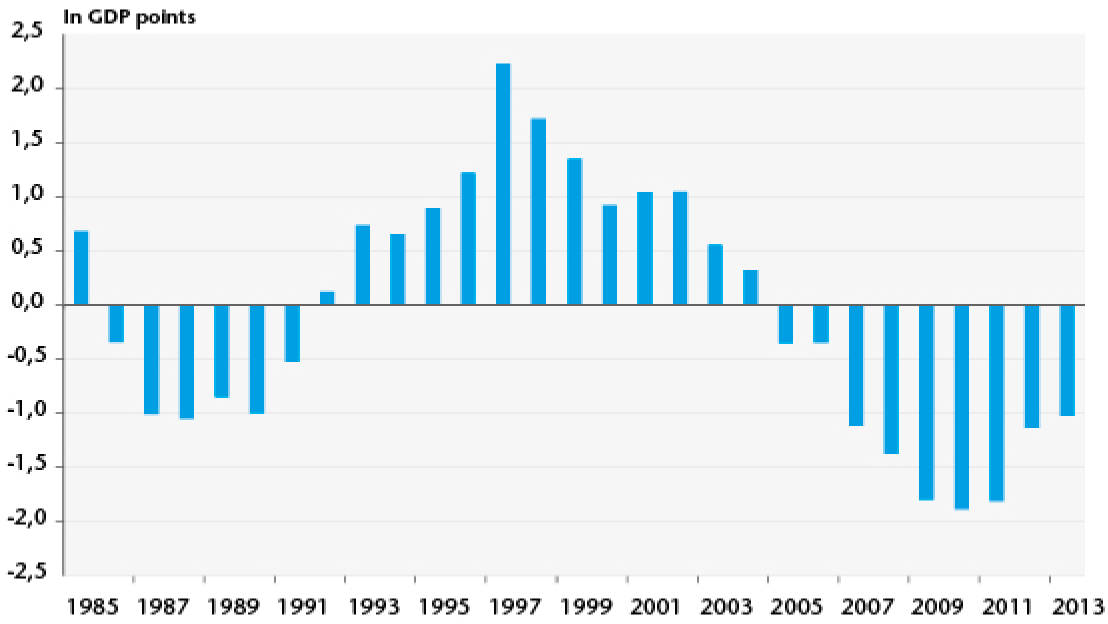
Is France’s trade deficit entirely structural?

By Eric Heyer

The issue at the heart of the debate between those arguing that a lack of supply is behind the low level of activity in France over the last four years and those arguing that the problem is a lack of demand is the nature of the country’s trade deficit.

On the one hand, the French economy has a number of symptoms characteristic of an economy experiencing a shortfall in demand: strong disinflation, high unemployment, businesses declaring substantial spare capacity due mainly to a lack of demand, etc. But, on the other hand, the existence of a persistent deficit in the trade balance (Figure 1) casts doubt on the competitiveness of French firms and on their capacity to meet additional demand, which would thus express a problem with supply.

Figure 1. French trade balance since 1985



Source: INSEE.

So, after more than ten years of trade surpluses, which represented over 2 GDP points in 1997, France's trade balance turned negative in 2005. After widening gradually until 2010 when the deficit reached nearly 2 GDP points, the trend turned around. In 2013 (the latest available figure), the trade deficit still stood at 1 GDP point.

This observation is not however sufficient to dismiss all the arguments of the proponents of a demand shortage that France simply suffers from a supply problem. What is needed at a minimum is to analyze the nature of the deficit and try to separate its structural component from its cyclical component. The latter is the result of a difference in the economic cycle between France and its major trading partners. When a country's situation is more favourable than that of its partners, that country will tend to run a deficit in its trade balance linked to domestic demand and thus to more buoyant imports. A trade deficit may thus arise regardless of how competitive the country's domestic firms are.

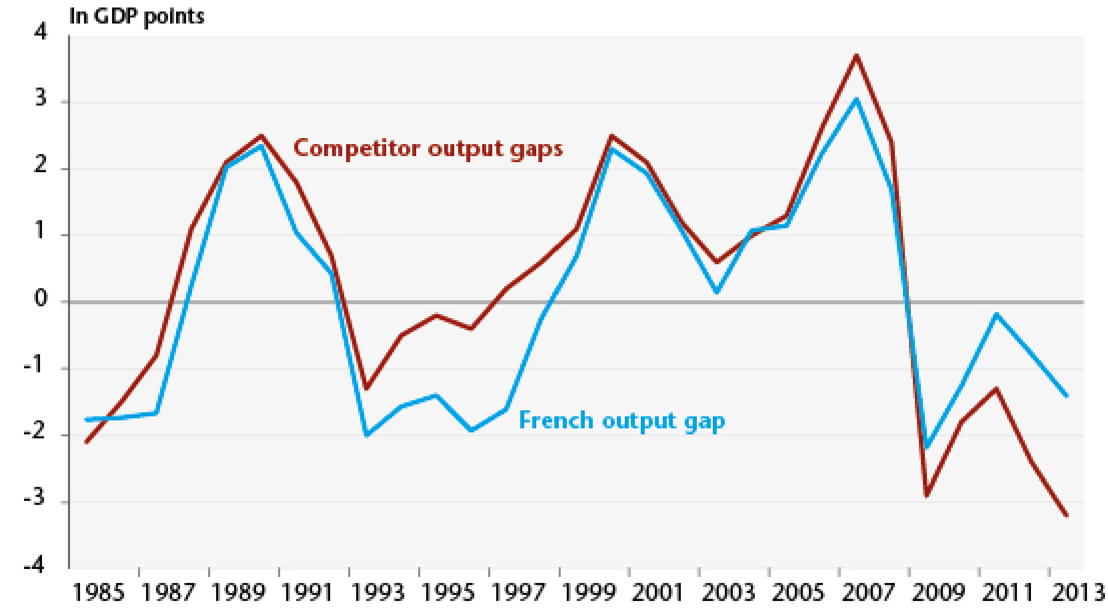
One way to take this cyclical gap into account is to compare the gaps between an economy's actual output and its potential output (the output gap). At the national level, a positive output gap (respectively negative) means that the economy is in a phase of expansion (respectively of contraction) of the cycle, which, other things being equal, should lead to a cyclical deterioration (or improvement) in its trade balance. In terms of the trading partners, when they are in a cyclical expansionary phase (positive output gap), this should lead to a cyclical improvement in the trade balance of the country in question.

Using data from the latest issue of the OECD's *Economic Outlook* (eo96), we calculated an "aggregate" output gap for France's partners by weighting the output gap of each partner by the weight of French exports to that country in France's total exports.

This calculation, shown in Figure 2, highlights two points:

1. The first is that, according to the OECD, France's output gap has been negative since 2008, signalling the existence of room for the French economy to rebound.
2. The second is that the economic situation of our trading partners is even worse. The cyclical gap, measured by the difference between the output gaps of France and of its partners, indicates a significant difference in favour of France.

Figure 2. The output gap of France and its main trading partners



Source: OECD, eo96.

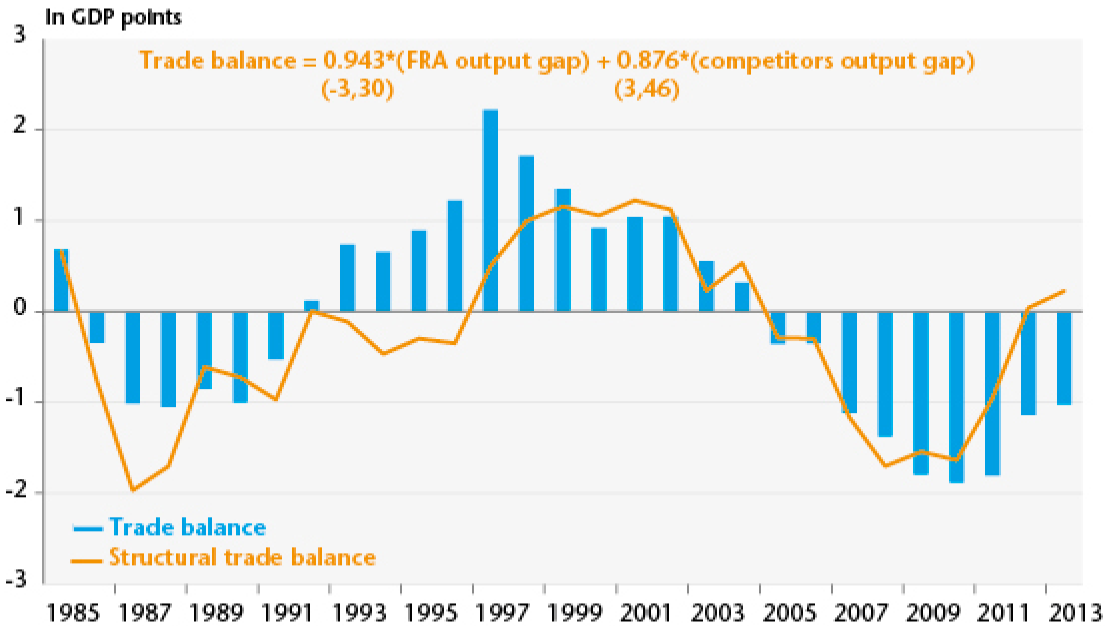
It is then possible to assess the impact of the cyclical situation of the country and that of its main partners on the trade balance.

A simple estimate using Ordinary Least Squares over the period 1985-2013 shows a relationship of cointegration between these three variables (trade balance, output gap of France and output gap of its partners) for France. The signs obtained are consistent with what we would intuitively expect: when France is in an expansionary phase, its trade balance tends to worsen (coefficient of -0.943). In contrast, when rival countries are experiencing a boom, this makes for an improvement in France’s trade balance (coefficient of +0.876).

France’s structural trade balance since 1985 can then be calculated by subtracting the cyclical effect (national and competitors) from the observed trade balance.

Figure 3 shows this calculation. First, the fall in the euro in the late 1990s led to a structural improvement in France’s structural balance. The sharp deterioration in the trade balance between 2001 and 2007 would then be entirely structural: it would be explained in particular by China’s entry into the WTO, by the competitive disinflation policy adopted by Germany, and by the appreciation of the euro. Since the 2008 crisis, however, an increasingly substantial portion of the French trade deficit would be cyclical. So even if French growth were sluggish, the country's economic difficulties were nonetheless less dramatic than in the case of some of its trading partners[1]. It is this relatively more favourable performance compared to its major trading partners that would have led to the rise of a trade deficit, part of which was cyclical. By 2013, the imbalances in the current account would be entirely cyclical in origin.

Figure 3. France's structural trade balance based on OECD data



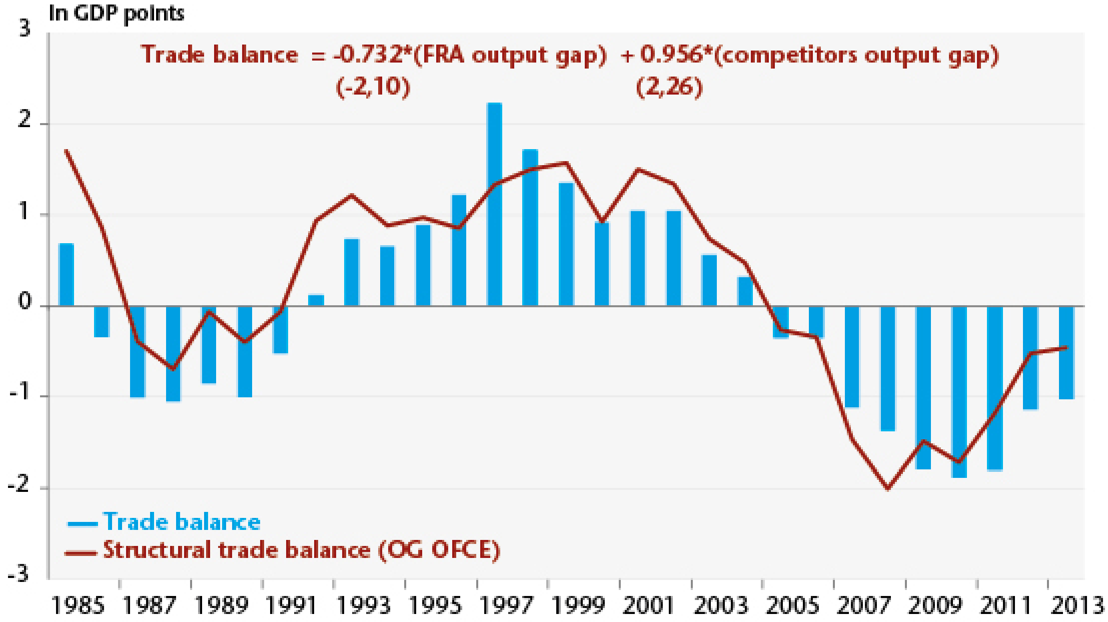
Source: OECD, eo96, author's calculations.

This result echoes the analysis provided by the French national accounting office on the factors driving growth over the last four years: the level of real GDP in the third quarter of 2014 was only 1.4% higher than in first quarter 2011. An analysis of the factors contributing to this performance is unambiguous: private demand (household and business) was down sharply (-1.6%), particularly household consumption, the traditional engine of economic growth. While there are more households today than four years ago, their total consumption was 0.6% below their 2011 level. However, while the French economy’s ability to deal with the global competitive framework is being questioned by the dominant discourse, foreign trade has in fact had a very positive impact in the last four years, with a boost from exports, which contributed a positive 2 GDP points to growth. In short, for four years the French economy has been driven mainly by exports, while it has been held back by private demand.

This analysis is of course based on an assessment of output gaps, whose measurement is tricky and subject to sharp revisions. In this respect, while there is an institutional consensus on the estimate that France has a negative output gap, there is also a broad range in the magnitudes of the room for a rebound, ranging in 2014 from 2.5 to 4 points, depending on the institution (IMF, OECD, European Commission, OFCE).

This diagnosis would be somewhat attenuated if an output gap were used for France that was more negative than the one calculated by the OECD: using the OFCE’s estimate for France (an output gap of -2.9 GDP points in 2013 instead of the OECD’s -1.4 points) and retaining the OECD measure for its partners, France’s more favourable relative performance compared to its major trading partners would now explain only half of its trade deficit[2]. Part of the deficit observed would therefore be explained by the competitiveness problems of French business (Figure 4).

Figure 4. France's structural trade balance based on OFCE data



Source: OECD, eo96, author's calculations.

In conclusion, as with any measurement of a structural variable, the evaluation of the structural trade balance is sensitive to the measure of the output gap. Nevertheless, it is clear from this brief analysis that:

- If the French economy is considered to suffer mainly from a supply problem (output gap close to zero), whereas our partners, mainly European, face a shortfall in demand (negative output gap), then the deficit in our trade balance would essentially be cyclical.
- However, if France, like its partners, is also experiencing a shortfall in demand, then only part of our deficit is cyclical, and the rest is related to a problem with the competitiveness of our companies.

This last point seems to us closer to the actual situation of the French economy. While French companies' have undeniably lost some competitiveness, this should not be overestimated: the sluggishness that has characterized our economy for nearly four years is due not only to a lack of supply and the disappearance of the potential for growth – even if this is unfortunately likely to taper off – it is also due to a significant decline in demand.

[1] For example, Italy and Spain entered a second recession in third quarter 2014, leaving their GDP lower than its pre-crisis level by 9% and 6% respectively.

[2] We find a similar result when the previous version from the OECD (eo95) it used for France and all its partners.

How France can improve its trade balance*

By Eric Heyer

Prime Minister Jean-Marc Ayrault has made a commitment to restoring France's balance of trade, excluding energy, by the end of his five-year term. Without addressing the curious anomaly of leaving the energy deficit out of the analysis of the country's trade position, as if it did not count in France's dependence on the rest of the world, we will examine the various solutions that the government could use to achieve this goal.

The first solution is to do nothing and to wait until the austerity policy that has been implemented in France through public spending cuts and higher taxes reduces consumer spending. In the face of higher unemployment and the resulting increase in household precautionary savings, the French will cut back on consumption. However, since some of this comes from outside France, this will limit imports into France from abroad and, everything else being equal, improve the country's trade balance.

This solution, it is clear, not only is not virtuous, as it relies on a reduction in employee purchasing power and rising unemployment, but it also has little chance of success, because it assumes that French exports will not follow the same path as imports and will continue to grow. However, since our partner countries are following this same strategy of a rapid return to balanced public finances, their austerity policies will result in the same dynamics as described above for France, thereby reducing their own domestic demand and hence their imports, some of which are our exports.

As a result, and since the austerity programmes of our partners are more drastic than ours, it is very likely that our exports will decline faster than our imports, thus exacerbating our trade deficit.

The second solution is to increase our exports. In a context where our European partners, who represent 60% of our trade, are experiencing low or even negative growth, this can be achieved only through gains in market share. Lowering the cost of labour seems to be the fastest way to do this. But in the midst of an effort to re-establish a fiscal balance, the only way to lower the charges on labour is to transfer these to another tax: this was the logic of the “social VAT” set up by the previous government, but repealed by the new one, which seems to lean more towards transferring these to the CSG tax, which has the advantage of having a larger tax base, affecting all income, including capital income.

But in addition to the fact that this strategy is not “cooperative”, since it resembles a competitive devaluation and thus is essentially aimed at gaining market share from our euro zone partners, there is no indication that it would be sufficient. Indeed, there is nothing to prevent our partners from adopting the same approach, particularly since their economic situation is worse than ours, and this would cancel all or part of any potential gains in our competitiveness.

The last solution consists of making the country more competitive by raising the productivity of our employees and by specialising in high value-added sectors that are not subject to competition from the emerging countries with their low costs.

This is a medium-term strategy and requires the establishment of policies to promote innovation, research and development, and training. It also means expanding the range of our traditional products such as automobiles, but also specializing in the industries of the future.

The need for a transition to an ecological mode of production that is more energy-efficient could represent this industry of the future, and therefore be the solution to our trade deficit.

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* This text is taken from a series of reports by Eric Heyer for the programme “Les carnets de l’économie” on France Culture radio. It is possible to listen to the series on France Culture.