Hollande’s crucial first task is to realise that “it’s the French economy, stupid”

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One of the key problems that the newly elected French president François Hollande will have to tackle is France’s weak and falling export competitiveness. **Bob Hancké** *suggests that this may not be quite as simple as some observers suggest: a large part of France’s economic policy-making has, due to the European monetary union (EMU), moved to Berlin – even before the current crisis – and another part depends on the strategic sourcing decisions of French companies.*

Berthold Brecht, the German playwright, once famously suggested that if rulers were not too impressed by their citizens, they could choose another electorate. Ironically, that may just be the feeling in Berlin, Brecht’s hometown, after François Hollande’s decisive win in last Sunday’s French presidential election. The German chancellor Angela Merkel somewhat clumsily tried to intervene in this process by supporting Nicolas Sarkozy, driven by fear that Hollande would rip up the recently agreed fiscal compact.

Credit: Francois Hollande (Creative Commons BY NC ND)

But what exactly does Hollande stand for? A face-off with Germany over the future of the Euro? Massive tax and spend policies at home? Retirement at 55, and a 35-hour working week? Almost certainly not – although judging by some headlines in the more conservative press, in the UK and abroad, this is almost certainly what will happen, with France sinking even deeper than it already has. So let’s have a look at what state the French economy is in at the moment, and how it got there. A snapshot, constructed from data in last week’s Economist (with Eurozone averages following between brackets) of key economic indicators:

Indicator	France	Eurozone average
Unemployment	10%	10.8%
Forecast 2012 GDP growth	0.1%	-0.5%
Inflation (CPI)	2.3%	2.4%
Budget deficit (% of GDP)	-4.7%	-3.4

Current account deficit (% of GDP)	-2.1%	-0.2%

The good news first: on most of these indicators, France is not massively out of sync with the rest of the EU or Eurozone – even though average figures do hide wide variation. The high unemployment rate and budget deficit in any case are probably less a consequence of the wrong economic policies and almost certainly a direct result of low growth across the Eurozone. When (if?) growth picks up again, these figures will undoubtedly improve. How and when is something that Holkel, Merkollande or Homer will have to thrash out over the next few weeks and possibly months.

The figure in this short round-up that worries me is the current account deficit. It is admittedly not massive (the UK has a current account deficit in the same range – 1.7% – and the USA has had a much larger one for several years). But it is a far cry from the surpluses that France ran in the 1990s. Between 1994 and 1999, France's current account surplus rose year-on-year, to reach about 3.5% and then fell, first slowly and then sharply, turning negative from about 2004 on. The standard explanation is the simple, nay simplistic, one that France no longer is competitive. This has to be true. By definition, in fact. But it is not an explanation: it describes the situation we are in, yet, crucially, lacks a mechanism that gets us there. Have French companies suddenly turned into Club Med outlets, perhaps, or have the famous long French lunches taken their toll? Some of that must have happened for French competitiveness to fall as much as it seems to have done.

This reversal in France's economic fortunes is not only worrying, but also puzzling. To find out why this might be, some of our Masters students and I began to dig into this during the summer of 2011 (the students, from whom I am borrowing much of the material for this post, but who are not to blame for my interpretations, are Famke Krumbmüller and Aude St Paul). We discovered that French companies have not suddenly introduced slack in their operations. Throughout the years of collapsing competitiveness, France still has boasted large, profitable companies – more in fact than in the earlier period when things seemed to be going well. Effort has, as far as we can tell, not really dropped either (with respect to the Club Med explanation). Real labour productivity in France has followed almost exactly the same upward pattern as Germany's since the early 2000s, and real unit labour cost (which measures real wages adjusted for labour productivity) has been flat in France between 1999 and 2008. Exports have roughly followed the same trajectory as Germany since the late 1990s: Germany performs slightly better, but France is very close on its heels throughout the decade. Yet, despite all that, France's current account deficit is large, and intriguingly, mirrors Germany's almost perfectly.

A close look at the divergence between Germany and France suggests two possible – complementary rather than competing – explanations. The first is, as Famke Krumbmüller suggests, related to trade in the context of EMU. While real unit labour costs (ULC) remained stable in France throughout the 2000s, Germany's ULC growth was actually negative. Since France and Germany are also each other's main trading partners in a low-growth Euro-zone, the stability of French ULC against the fall in German ULC necessarily implied that France became less competitive – even (and this is important) when wage costs in France were kept under control. Before EMU, this would have led to a depreciation of the real effective exchange rate (through a combination of nominal adjustment, trade diversion and wage moderation). In EMU, that is much harder, since the nominal exchange rate (the first channel of adjustment) no longer exists, trade diversion is not easy, and wage moderation is not a problem in France, as flat ULC curves suggest (but, ironically, may have become that because of Germany's excessive wage moderation).

The second way to get our heads around the problem is slightly more pernicious: Germany simply did something right that France did not. Aude St Paul makes the point that Germany's foreign direct investment (FDI) to central Europe, where it is the main investor, does not so much compete with existing export activities at home as complement those. France's FDI, in contrast, substitutes much more for activities that take place in France. The aggregate numbers are quite revealing: Germany's annual new FDI was about $16 billion over the 2000s, whereas France's was about $13 billion. Adjusting for size of the economy, this is more or less the same. But in France, about $8 billion of investment disappears each year, while in Germany that is only $6 billion.

Why this difference? German companies seem to outsource discrete activities along the value chain: for each sub-activity they look for the optimal location to do it. Where skills remain important and wage costs are (in part as a result) less important, German companies search for ways to stay at home to make the most of their skilled workforce. When costs make up a large part of the product in that stage in the value chain, German companies try to locate those activities in low-cost jurisdictions. Put simply, German companies exploit comparative institutional advantage, and make sophisticated export products and services as a result. French companies do almost the opposite: they locate abroad when they can, not when they have to, and close plants at home. They do that because, in contrast to German companies, their technologies are more standardized and their products face tougher cost competition. Perhaps French workers should elect new managers?

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