PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 3 (1433), 13 January 2020 © PISM

Better than Germany? France's Economy Improving

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The year 2019 was good for the French economy, mainly because of reforms undertaken in recent years, low interest rates, and pragmatic fiscal policy. However, unemployment, the public debt, and protests against the reforms are among the biggest challenges for maintaining the momentum. If these can be overcome, France can count not only on a lasting improvement in its economic situation but also greater political influence in the EU.

In the last decade, European public opinion has become accustomed to a specific division of roles between the largest economies of the eurozone: Germany as the leader and model for effective economic policy and France the "eternal second", unable to undertake much-needed reforms. This perception was well-founded until recently. While Germany consistently recorded solid growth, falling unemployment, and surpluses in the state budget, France struggled with the crisis in its labour market and had one of the highest public debt ratios on the continent (see Annex).

However, the last few quarters have seen a break in this pattern with France starting to grow significantly faster than Germany. According to European Commission estimates, the French economy grew by 1.3% in 2019 while Germany's managed only 0.4%. In the coming years, France is likely to maintain its advantage in growth. The better results create the chance of an end to the stagnation ongoing with a few breaks since the presidency of Jacques Chirac. The data also encourage speculation whether the Fifth Republic is on its way to replacing Germany as the eurozone's economic leader.

Sources of Growth. The reforms undertaken since the beginning of Emmanuel Macron's term as president prepared the ground for the good GDP results. In 2017, the government amended the labour law to facilitate easier dismissal of employees and reduce severance costs. Therefore, companies increased employment, less afraid of being locked into these workers in the event of a worsening economic situation. The reforms also limited trade union influence by supporting direct negotiation of working conditions between management and employees, which enables companies to more flexibly respond to market conditions.

Other important changes concerned fiscal matters. The wealth tax was reformed (now focused more on property holdings) and instead of a progressive tax on capital gains, a uniform rate of 35% was introduced. This was accompanied by various facilitations for companies, including reductions in bureaucratic barriers and fiscal burdens. In 2019, the government also began rebuilding the unemployment benefits system. The conditions for access to benefits have been tightened and transfers reduced. Greater access to the system was granted to self-employed workers and people planning to set up their own business.

These changes were among the factors supporting the relatively higher level of investment in France—by about 1.5-2% of GDP—than Germany. Thanks to this, the economy adapted faster to the challenges of digitisation, electromobility, and the energy transformation. In the latter, France has a considerable advantage in the form of cheaper nuclear energy, a sector from which Germany has been withdrawing since 2011 by implementing its ambitious and very expensive *Energiewende* programme. The French economy also was boosted by foreign investment in the financial sector, which benefited from banks and funds moving from London to Paris in the face of Brexit.

Macroeconomic policy also favoured growth in France. In implementing the structural reforms, Macron did not abide by budget austerity, aimed at reducing the still-high deficit in public finances. After the "yellow vests" protests started a year ago, he even decided on an additional fiscal package, thanks to which consumption and investment were revived and the protests quenched, albeit at the price of maintaining a high deficit (3.1% in 2019). The pro-growth effect of the package was further strengthened by the low-interest-rate policy pursued by the European Central Bank (ECB), which prompted French companies to take larger loans for new ventures.

Challenges. The better condition of the French economy is undisputed, but the chances the country will take over Germany's role as the EU's economic leader are limited. First, GDP growth of 1.3% can hardly be called a boom. In addition, France's performance reflects its much lower dependence on foreign trade and global economic conditions than Germany. The growing risk of trade wars and the decline in orders in emerging markets has turned what was an advantage for German companies—the ability to export at 47.4% of GDP—into a drag. However, this condition will not remain forever. If global economic conditions improve, Germany's economy will accelerate faster.

There are also reasons to carefully assess France's economic prospects. One should point to the risk associated with budget deficits and huge public debt (see Annex), which has been oscillating at close to 100% of GDP for years, much higher than Germany's (below 60% of GDP). Currently, expenditures on financing and debt service are inexpensive due to record-low interest rates but if they increase in the future, the stability of the French economy will be called into question.

The second challenge is the situation on the labour market. Despite the successes of the current authorities to counter unemployment, 8.5% of economically active people remain without a job—more than two and a half times that of Germany (see Annex). At the same time, there are many vacancies, which points to further, serious structural problems (e.g., in the education system). There is no doubt that France still needs many difficult reforms but forcing them is—as Macron's predecessors have found—associated with a high political risk due to the tradition of protests and the strength of trade unions.

The current test of the ruling camp's determination is the reform of the pension system. President Macron strives to reduce the privileges of individual professional groups and unify pension policy, divided now across 42 subsystems. It also aims to encourage the French to work longer by changing the level of benefits paid. The reform plans have met great resistance from the public. In view of the strikes ongoing since the beginning of December 2019, the fate of the changes is not given.

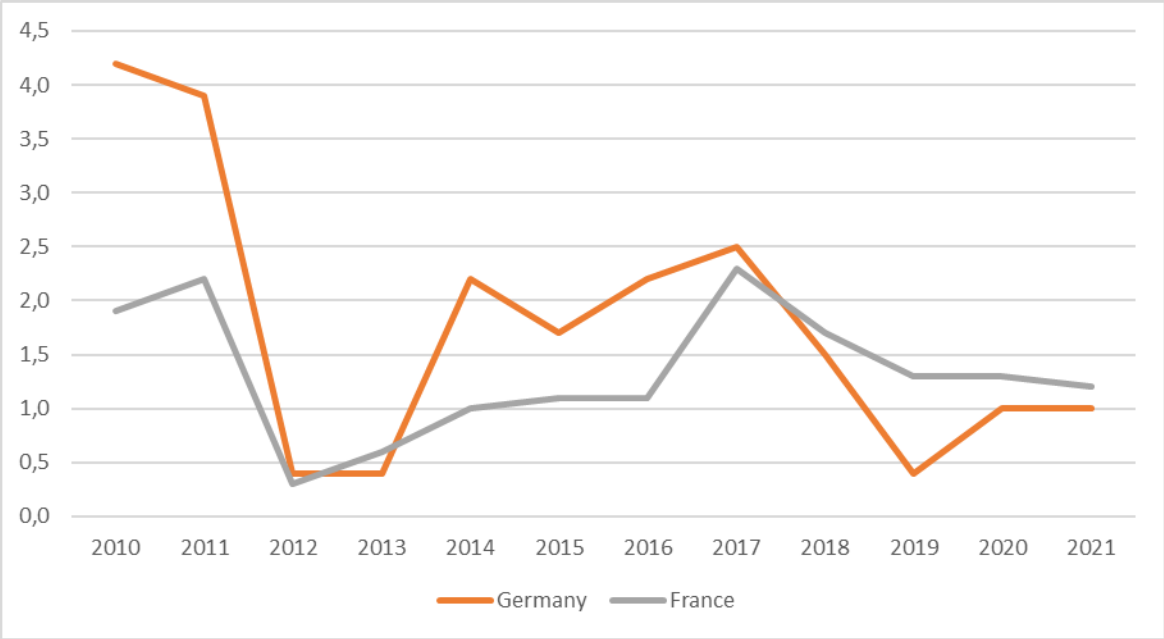
Conclusions. The improvements in the economy have strengthened President Macron politically and allow him to be more optimistic about his chances of re-election in 2021. The growth is also quite important for the EU economy because France, with its GDP of €2.3 trillion, provides significant support to the region, especially in view of Germany's current weakness. The positive economic data also give Macron more room for manoeuvre in European politics. Until now, his ideas about reforms of integration institutions have often been dispelled by the argument that the French authorities should primarily deal with repairing their own economy. Today, the current improvement has made France's ambition to play the role of the EU's leader more credible.

Macron can take advantage of the current situation to, in particular, stimulate a discussion about the European social and economic model and the future of the euro area. It can present its success as the result of a reasonable combination of market reforms and state activity and contrast it to the German vision based mainly on restrictive fiscal policy. France could, therefore, proceed to a more offensive push of its own priorities in the euro area: finalisation of the banking union, loosening fiscal policy, the introduction of Eurobonds, and a welfare union.

From an economic point of view, lasting improvement in France's economy would be very beneficial for Poland because it would mean, foremost, a chance to increase exports, both to France (€12.5 billion in 2018) and to the entire euro area. Better conditions in the Fifth Republic can also be regarded as a good omen for the upcoming negotiations on the multiannual financial framework and an opportunity for the French government to be more flexible regarding the scale and directions of joint spending. However, other effects of this situation may be negative for Poland, particularly if a consequence is even greater determination on Macron's part to push his vision of the EU, which consists of slowing enlargement, differentiating integration, or a "reset" with Russia. If so, the long-awaited improvement of mutual relations will not occur soon.

Annexe

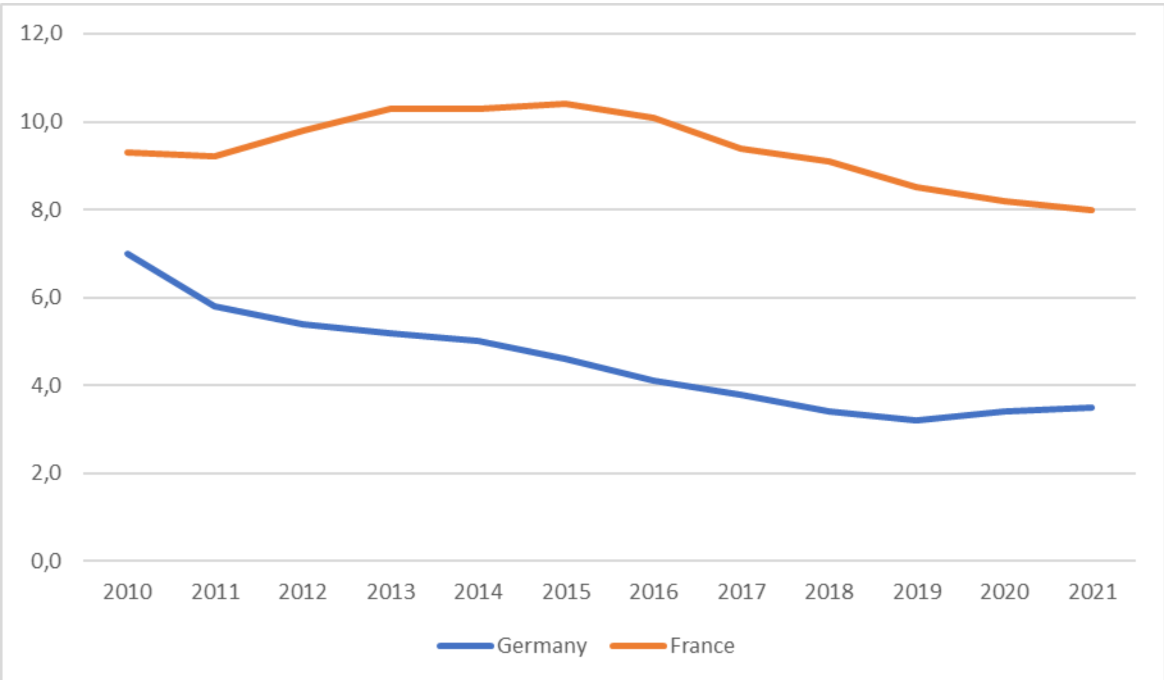
Figure 1. GDP Growth in France and Germany in 2010–2021*, in percent



* 2019–2021: forecast

Source: Eurostat, European Commission.

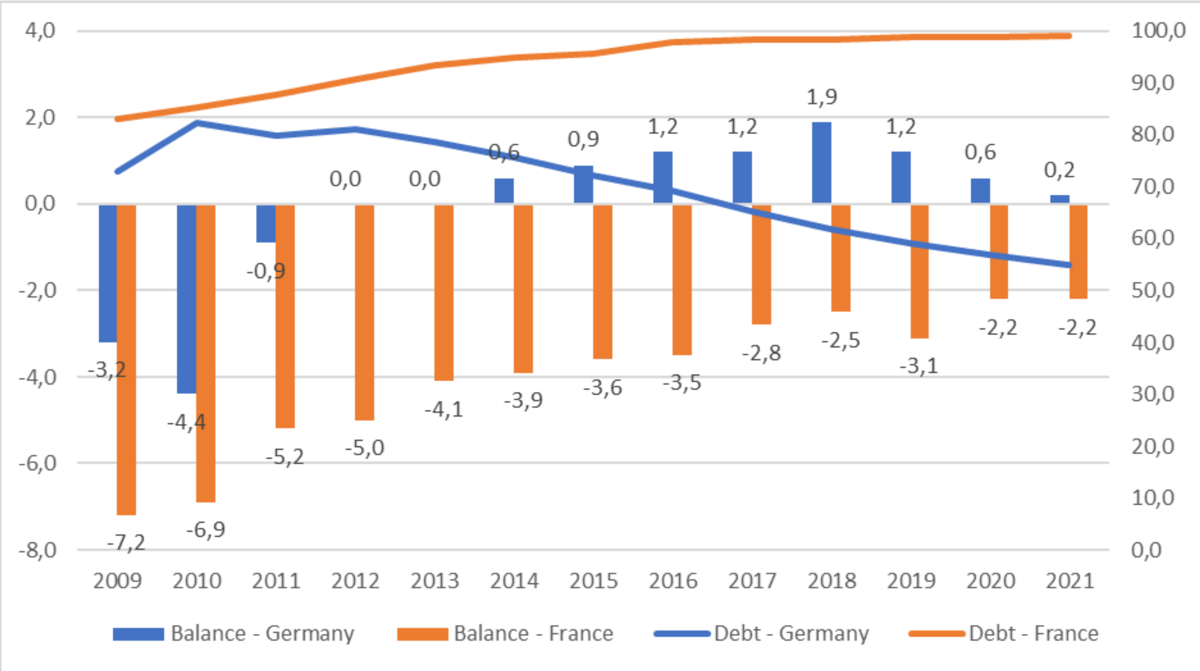
Figure 2. Unemployment in France and Germany in 2010-2021*, as a percent of the labour force.



* 2019–2021: forecast

Source: Eurostat, European Commission.

Figure 3. General Governance Balance and Gross Debt in France and Germany in 2010–2021*, in percent of PKB**



* 2019–2021: forecast

** left axis = annual balance; right axis = debt level

Source: Eurostat, European Commission.