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Research Report

Is France a restructuring case or Germany?

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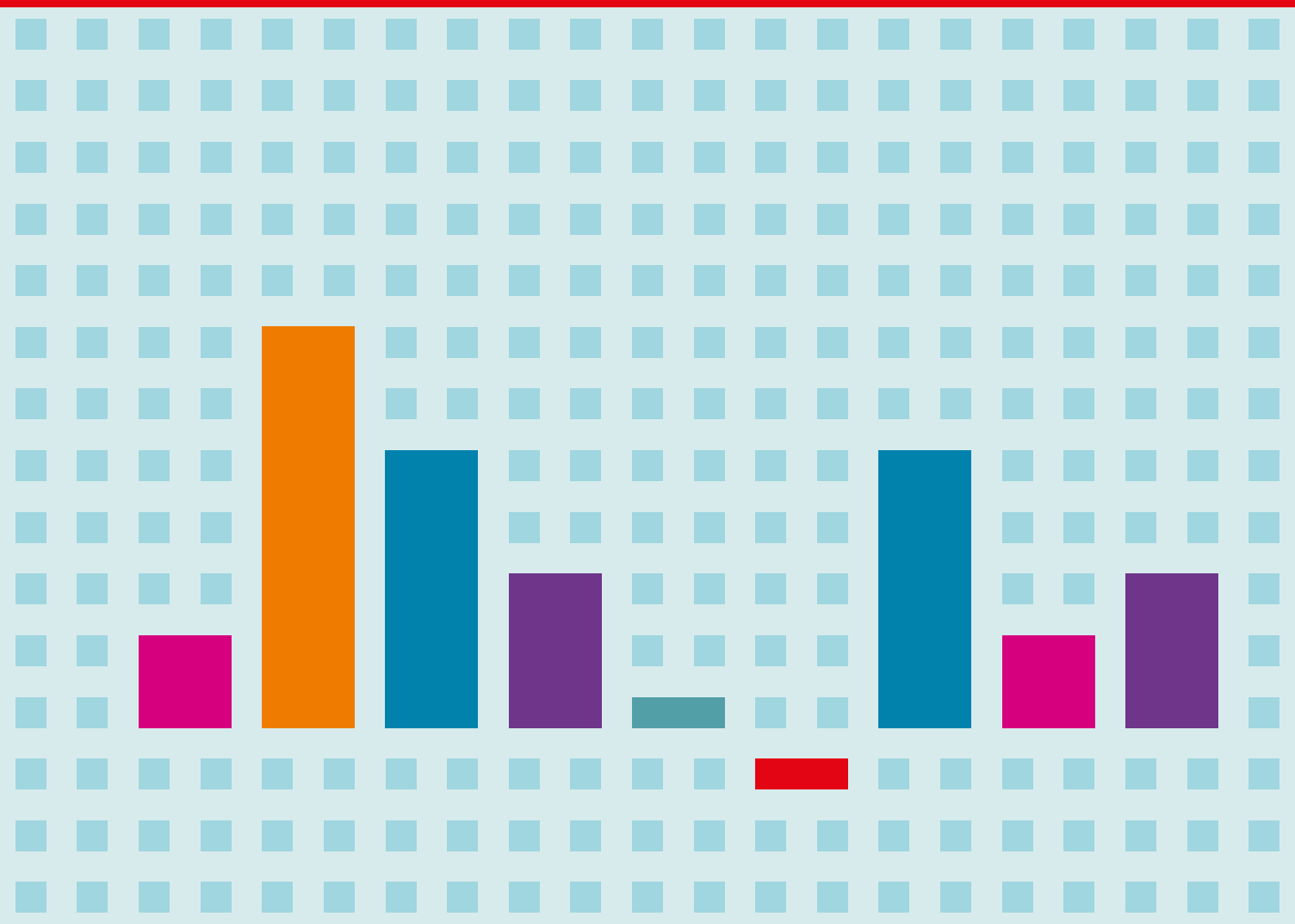
POLICY BRIEF

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IMK Policy Brief, November 2018

IS FRANCE A RESTRUCTURING CASE OR GERMANY?

Gustav A. Horn, Sebastian Watzka



IMPORTANT DECISIONS PENDING

Shortly after the parliamentary elections in September 2017, French President Macron made far-reaching reform proposals for the EU as a whole, but also for his own country (Macron 2017). His approach reflects a twofold view that France, as a national economy, has a considerable need for reform and that many economic problems can only be solved in a European context. In this respect, the French President's proposals rest on two pillars, one national and one European. While the national measures could relatively easily be implemented by him in view of the majority situation in the French parliament, he relies above all on the support of Germany for the European proposals. However, this support has so far been very hesitant.

Although an agreement was reached with the Meseberg Declaration within the framework of the Franco-German government consultations, this is to be understood, against the background of French ideas, more as a minimal solution for future reforms of the euro area. In particular, the German government continues to block any substantial progress in completing the banking union through joint deposit insurance. Germany's support for Macron's ambitious reform proposals can therefore be seen as rather half-hearted.

The resulting breathing space in the European reform process should be used to take stock of economic trends both in France and in Germany since the beginning of monetary union in order to draw conclusions for a reform process in the interests of both countries. In the context of a cycle comparison, similarities and differences in the reactions to recent crises are to be worked out.

This analysis highlights the importance of two phases in particular. On the one hand, the long phase of stagnation with the accompanying wage restraint in Germany at the beginning of the last decade has left deep traces with regard to the relative competitiveness of both countries. Secondly, the French economy has coped much worse with the financial market crisis than the German economy. At the same time, however, the German-French comparison in particular shows how low the wage increases in Germany really were at the beginning of the monetary union and how they have only caught up since the financial market crisis. At the time, this was reflected in correspondingly weak domestic demand in Germany. This has changed since the

financial market crisis. In this respect, it is also in the interest of the German government to secure this by now more dynamic domestic demand position with foreign trade.

GROWTH: THE LOST SYNCHRONICITY

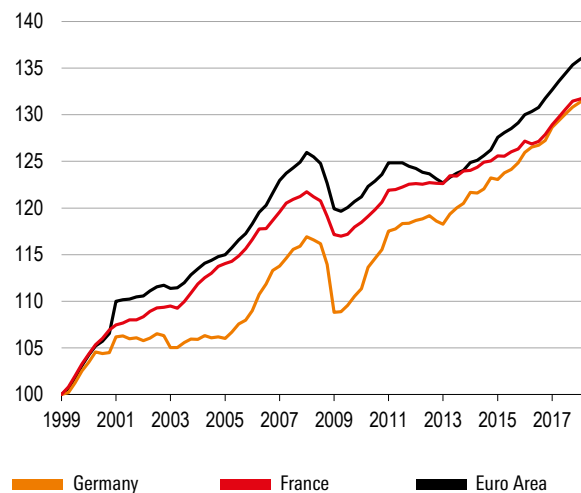
Sometimes the impression is given that France has replaced Germany as the "sick man" of Europe and that it can only be put on a sustainable course for growth and employment through "market-oriented structural reforms", what usually refers to institutional supply side reforms (SVR 2016, paragraph 428). However, the actual picture is much more complex and will be examined in more detail below. A look at GDP growth reveals a surprising coincidence. Since the beginning of monetary union, GDP in Germany and France has increased equally. There is therefore no general growth gap between the French economy and the German economy. However, it should be noted that both economies lag behind the euro area (Figure 1).

The same overall growth has, of course, taken place in different phases. In simplified terms, two phases can be distinguished: the phase from the beginning of monetary union to the beginning of the financial crisis, and the still ongoing phase since the financial crisis. After a period of

Figure 1

GDP development since the beginning of monetary union

01.01.1999=100



Sources: Eurostat; Macrobond.

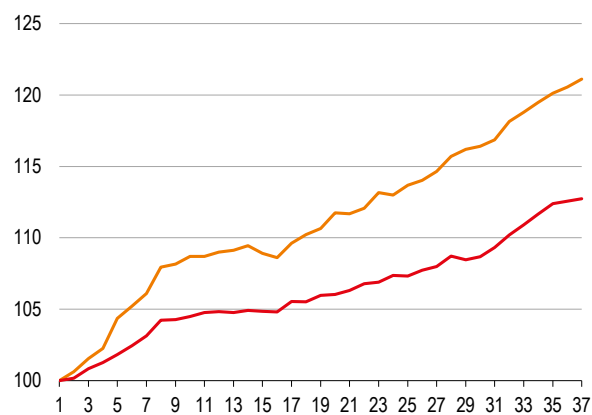


Figure 2

GDP development before and after the financial crisis

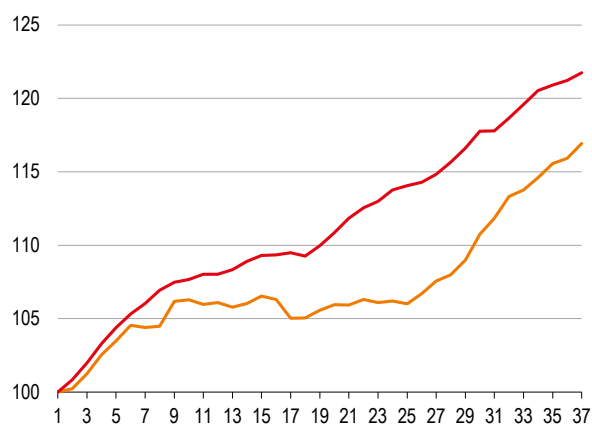
a) after the financial crisis (since 01.04.2009)

01.04.2009=100



b) before the financial crisis (01.01.1999 - 01.01.2008)

01.01.1999=100



Germany France

Sources: Eurostat; Macrobond.



synchronisation at the beginning of monetary union, the German economy clearly fell behind the French economy in the years 2001 to 2005 (phase 1). From 2005 until the onset of the financial market crisis, growth rates were equal again, with slight advantages for Germany. During the financial market crisis until 2009, growth in Germany slumped much more sharply than in France. Since then (Phase 2), however, the German economy has grown noticeably faster and has now fully made up for its previous growth shortfall. So when we talk about a crisis in France and the strong economy in Germany, we must refer to the time since the financial market crisis.

The significance of the financial market crisis for the growth differences is particularly striking in an explicit comparison of the two paths before and after the financial market crisis. Before the financial market crisis, France had a growth advantage over Germany, with Germany catching up somewhat in the end. During the crisis, Germany fell far behind again. Since then, however, growth in Germany has been noticeably stronger (Figure 2).

This is also confirmed by a comparison of the most recent upswings.¹ In the most recent upswing since 2013, the German economy grew noticeably faster than the French. In particular, however, the recovery immediately after the financial market crisis in Germany was much faster and stronger. Just over a decade ago, the upturns in the two countries hardly differed at all (Figure 3).

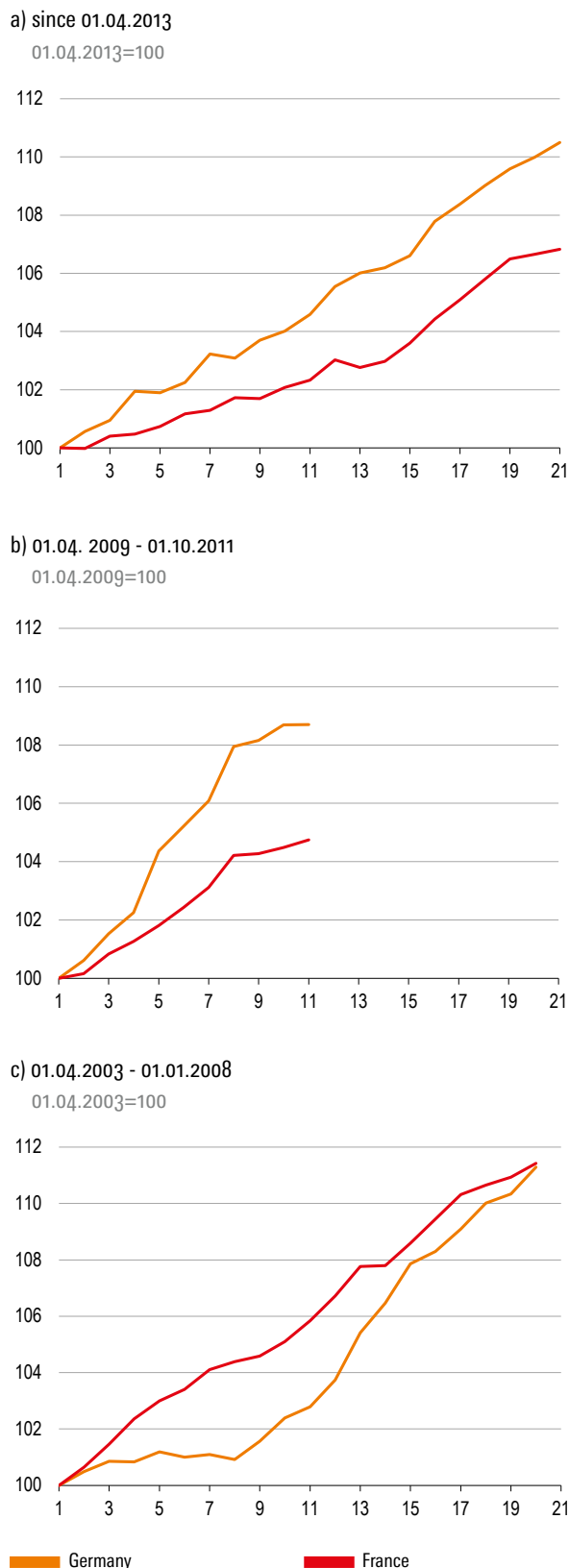
Despite all this, however, it should not be forgotten that the development of prosperity, which can be measured on the basis of GDP per capita, was clearly in Germany's favor overall because of different demographics. This is easily explained by the fact that overall growth was the same, but the population growth in France was higher. In the 2000s, however, per capita growth in France was higher than in Germany, despite higher population growth. Since the upswing in 2005 - interrupted by the financial market crisis - this trend has, however, turned in a striking form. An ever-widening gap has arisen in favour of Germany. Thus, since the financial market crisis, there has been a widening economic prosperity gap between the two countries (Figure 4).

It follows from this presentation that both economies started the monetary union with similar dynamics. However, the synchronicity of economic development has been lost with monetary union. Initially Germany fell behind and then France since the financial crisis. Although the growth result has so far been the same overall, extrapolating the differences in recent dynamics into the future reveals serious potential for tensions between the two strongest economies of the Monetary Union. There is therefore a need for economic policy action.

¹ For methodology see Horn et al. 2017.

Figure 3

GDP development in the last three upswings

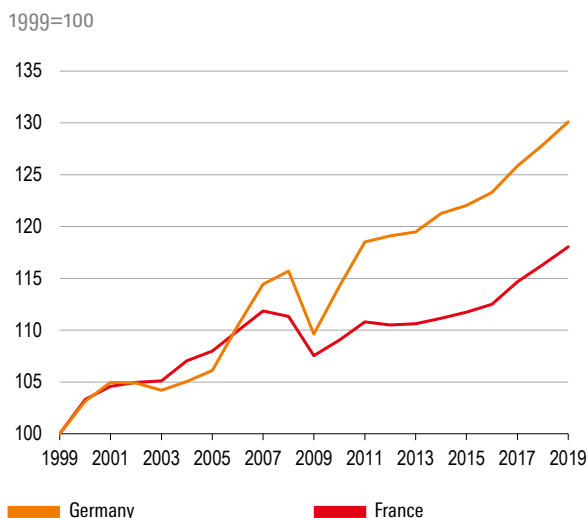


Sources: Eurostat; Macrobond.



Figure 4

Development of living standards since the beginning of monetary union



Sources: OECD; Macrobond.



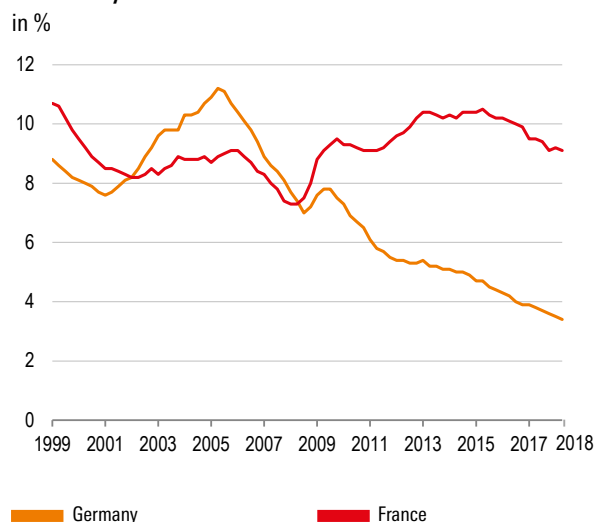
UNEMPLOYMENT ON DIFFERENT PATHS

The most serious aspect of asynchronicity can be seen in the recent divergent labour market trends. The poor performance of the French economy since the financial market crisis is reflected in developments in unemployment rates. Until the financial market crisis, the unemployment rate in France was lower than in Germany. Since then, the opposite has been the case and the gap in favour of Germany is widening year by year. It is this worrying trend from a French perspective that justifies the view of a restructuring case in France (Figure 5).

However, this process had already begun before the financial market crisis in 2005, when the unemployment rate in Germany reached its peak. As shown above, both economies experienced a similarly strong upswing up to the financial market crisis. Nevertheless, the unemployment rate in Germany fell much more sharply than in France. It is noteworthy that the volume of work, i.e. the number of hours worked, rose slightly more strongly in France than in Germany, as explained below (Figure 8a). By contrast, labour productivity per hour developed somewhat more dynamically in Germany (Figure 6). However, neither is by any means sufficient to explain the wide divergence in unemployment.

Figure 5

Development of unemployment rates since the beginning of monetary union



Sources: Eurostat; Macrobond.



Consequently, institutional changes in the labour market must have been significant. And this was precisely the case in Germany with the Agenda 2010. It became clear relatively soon after the Agenda came into force that statistical effects such as the correction of double counting and increased pressure on the unemployed with regard to the obligation to disclose personal financial wealth contributed to the rapid reduction in the unemployment rate in Germany, which was largely independent of general economic developments (Horn and Logeay 2007). Later studies systematically confirmed the first impressions (Klinger and Weber 2016; Stops 2015). Thus, the divergence between the German and French labour markets in terms of unemployment in this phase can be explained to a large extent by the initial effects of the Agenda 2010.

Especially since the financial crisis, the decline in unemployment in Germany has continued in an impressive manner, both in absolute terms and especially in relation to France. While unemployment in France has remained higher than before the financial market crisis, the German economy is gradually moving towards full employment. This has now opened up a very significant gap in labour market performance in favour of Germany and to the detriment of France.

On the other hand, the good developments in unemployment rates in Germany did not come at zero cost. On the contrary: the agenda reforms of the labour market are still contributing to the fact that a number of indicators of labour market performance are poor for Germany. For example, real hourly wages in Germany in 2010 were only at the 1999 level, while wages in France had grown – with the same productivity trends – by 13 % (Figure 6). The Agenda reforms and in particular the introduction of so-called HARTZ IV also led to a current poverty risk among unemployed people in Germany of 70%. The risk of impoverishment as an unemployed person is thus highest among all EU countries in Germany. Not only that, but the risk of poverty is also higher among the employed in Germany than in France (Figure 7). The Agenda reforms were therefore also partly responsible for the fact that a new precariat was emerging in Germany, which - unemployed or not - remains excluded from progressive prosperity.

Figure 6

Labour productivity and real wage development



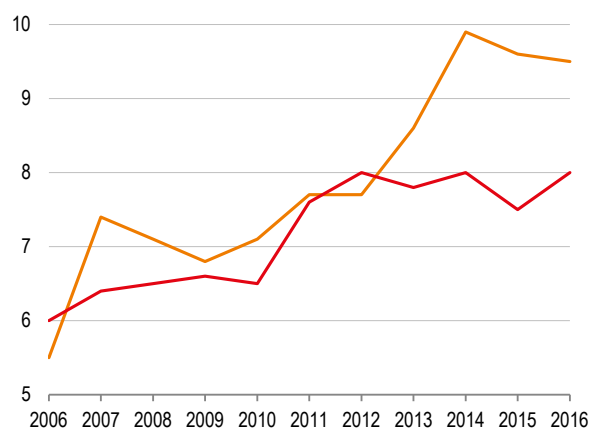
Sources: ECB; Macrobond.



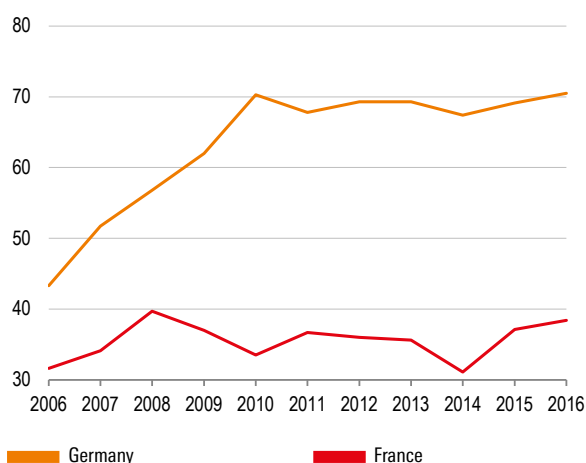
Figure 7

risk-of-poverty rates in %

a) of employed persons



b) of unemployed persons



Sources: Eurostat; Macrobond.

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EMPLOYMENT DEVELOPMENT: NUMBER OF HOURS WORKED VERSUS NUMBER OF EMPLOYEES

These remarkably divergent tendencies in labour market developments since the financial crisis in two so closely intertwined economies need explanation. In contrast to the period from 2005 to 2007, labour market reforms cannot be decisive in this respect. There were no significant labour market reforms in either country during this period. The reference to a NAIRU noticeably lowered by the Agenda 2010 is not convincing for this period. This is because wage growth in Germany has accelerated markedly in this period compa-

red to before and to the other euro area countries. It is currently the subject of numerous studies with which NAIRU this is compatible or whether these relationships have been structurally changed by the crises.

The picture of a weak French labour market is also changed by a closer look at employment trends. The number of hours worked, a measure of the total volume of employment, has actually risen less strongly in Germany than in France since the start of monetary union (Figure 8a). This applies to a significant extent until 2009, i.e. until the trough of the financial crisis, when the number of hours worked in Germany fell more dramatically than in France due to the much stronger economic downturn. Since then, however, France's lead has melted somewhat. The higher growth impulses in Germany since that time have left their positive mark on the labour market, although the level of the total number of hours worked in Germany has so far not risen above that of France.

A different picture emerges if one takes the number of employees as a yardstick. In France, this has risen by around 14 % since the start of monetary union, while in Germany it has risen by slightly more than 15 % (Figure 8b). After initial synchronicity, Germany was falling back, until around 2005 when this trend had been noticeably reversed and even intensified after the financial crisis.

These findings inevitably lead to conclusions for the average working time per capita. It is noticeably lower in Germany than in France. After all, a lower volume of work is realised with a higher number of employees. In Germany, the trend is almost constantly declining. In France, on the other hand, a decline of a similar magnitude has only been observed since 2013. These trends reflect the relatively high importance of part-time work in Germany. Women in particular choose part-time work voluntarily or involuntarily. With regard to the number of employees, the trend towards part-time work reinforces Germany's lead. The labour market is obviously absorbing more strongly here, and this explains why the increase in the number of employees was higher in Germany.

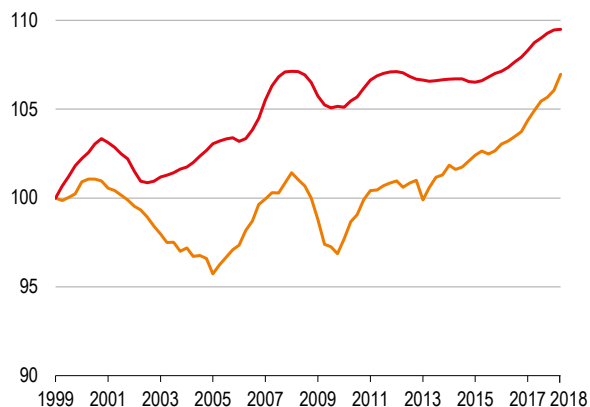
The employment developments during the recent cyclical upswings fit well into this overall picture. Just over a decade ago (since 2003), the number of employees in France rose just as strongly as in Germany during the upswing (4 %).

Figure 8

Employment

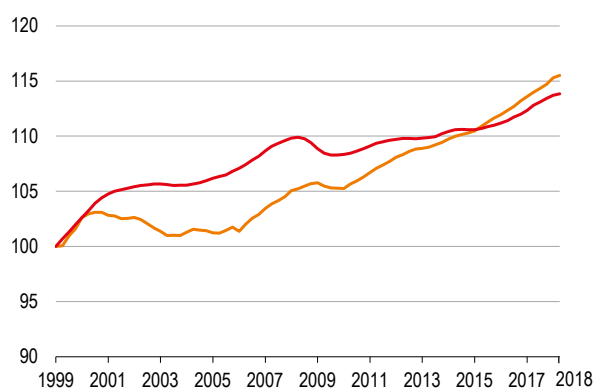
a) Number of hours worked

01.01.1999=100



b) Number of persons employed

01.01.1999=100



Germany France

Sources: ECB; Macrobond.



However, even in the short recovery phase following the financial crisis, employment levels in Germany rose somewhat more strongly (2% versus 1%). This trend reversal continued in the recent upswing, in which employment in Germany increased noticeably more strongly (Figure 9). All in all, a marked divergence in employment trends before and after the financial market crisis can thus be observed in the two countries (Figure 10).

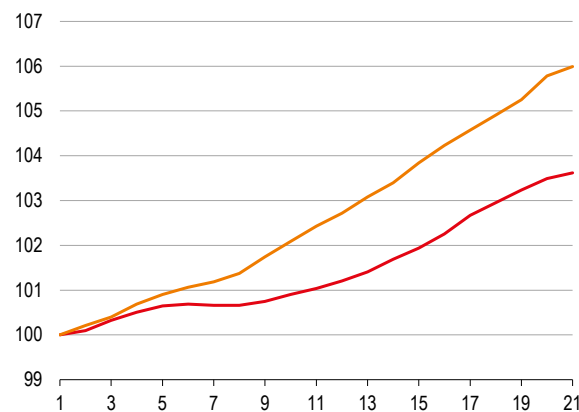
It must also be borne in mind that the demographic conditions in the two countries were quite different. Until 2011, the total population increased in France, but declined in Germany. However, this divergent effect was not reflected to the same extent in the labour force poten-

Figure 9

Employment (persons) in the last three upswings

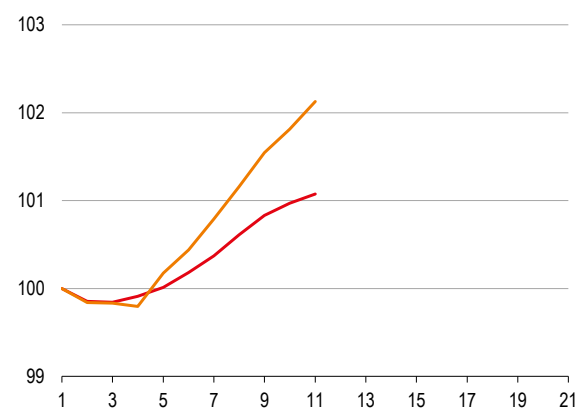
a) since 01.04.2013

01.04.2013=100



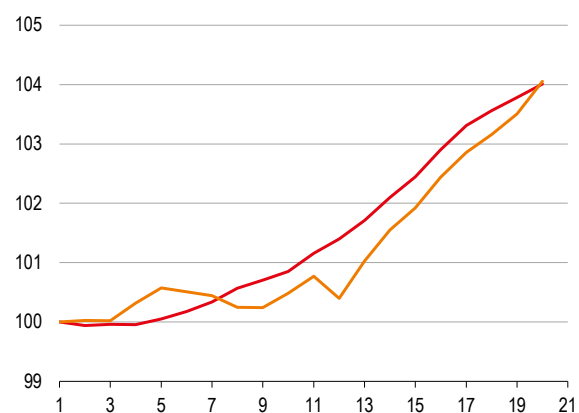
b) 01.04.2009 - 01.10.2011

01.04.2009=100



c) 01.04.2003 - 01.01.2008

01.04.2003=100



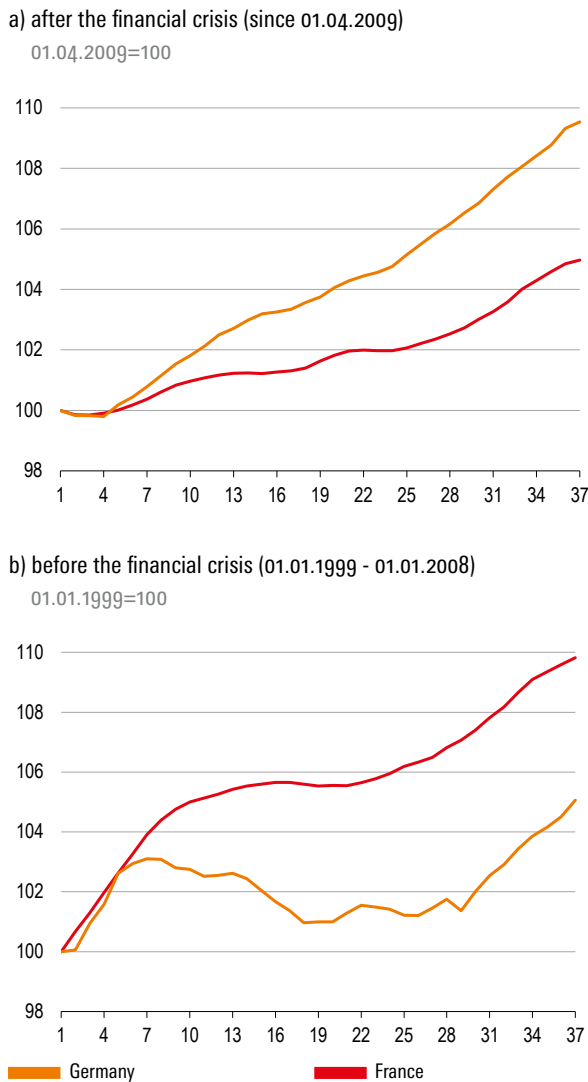
Germany France

Sources: ECB; Macrobond.



Figure 10

Employment (persons) before and after the financial crisis



Sources: ECB; Macrobond.

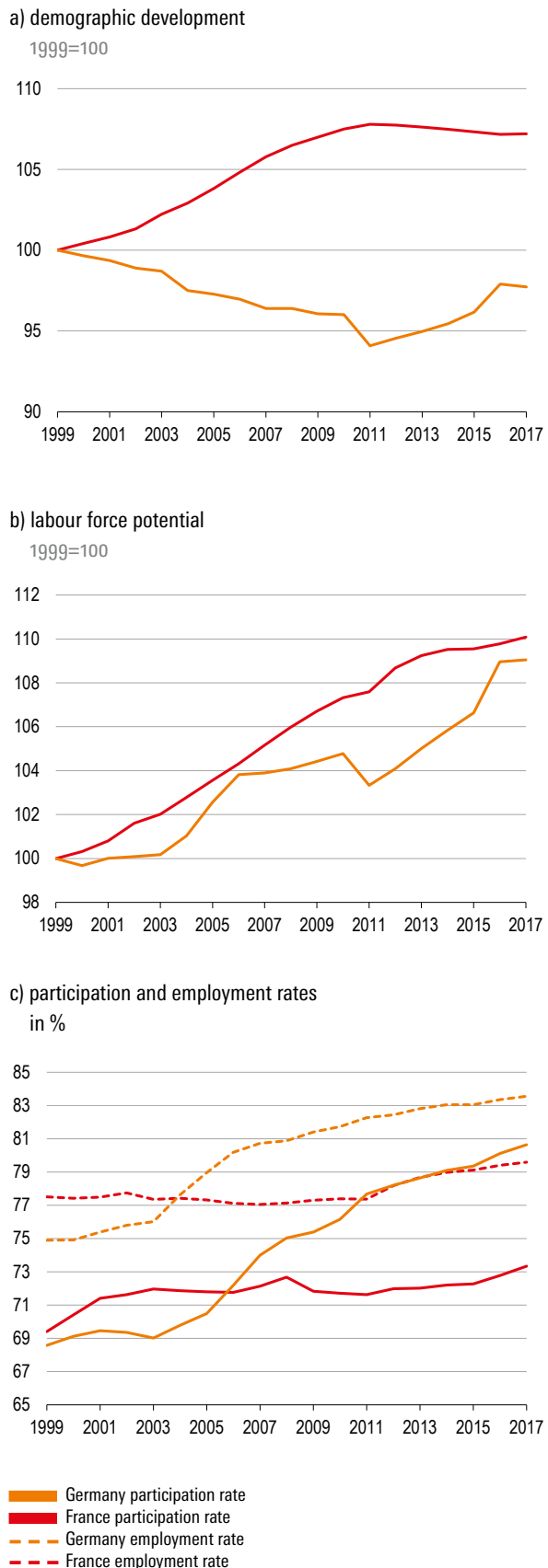


tial.² Nevertheless, the stronger increase in the labour force compared to Germany means that the absorption requirements on the French labour market had increased more strongly than for the German labour market. Since 2011, however, these trends have changed again. While the supply of labour is almost stagnating in France, it is now increasing strongly in Germany (Figure 11). Against this background, a trend towards higher unemployment in France than in Germany would come as little surprise before 2011, while the opposite would be more plausible since 2011.

2 Measured in each case at the age between 25 and 64 years.

Figure 11

Demographic development and the labour market



Sources: OECD; Macrobond.



THE BALANCED UPSWING

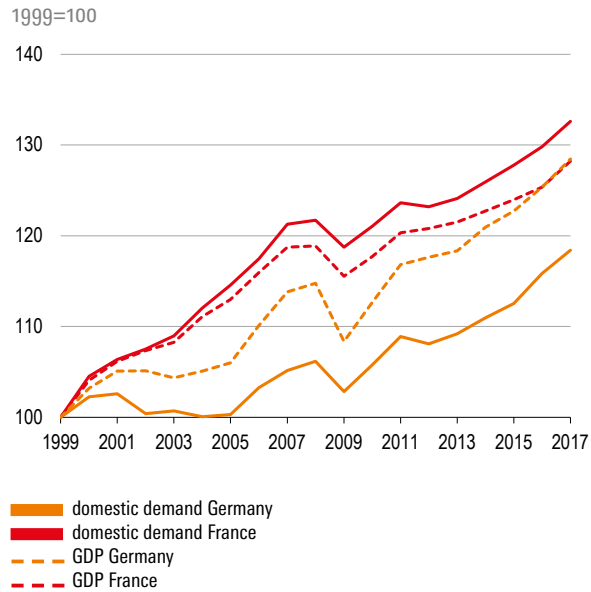
Figure 12

In the last decade, with effects that have partly lasted until today, the one-sided narrative that Germany was a small open economy that could be successful in the global competition only with superior supply conditions was dominant in German economic policy. This view was propagated above all by the German Council of Economic Experts and Hans-Werner Sinn (SVR 2002; Sinn 2003). In the logic of such a narrative, overall economic success is in essence strongly linked to exports. They alone serve as proof of success in global economic competition. As a result, domestic economic policy must above all be competitive and generate export success. A flourishing domestic demand - based on high-income consumers and innovative entrepreneurs - was completely absent from the neo-liberal dogma of German economic policy discussions at the turn of the millennium. In France, this view was by far not so influential (Piketty 2017). In this respect, the result is ultimately not surprising in terms of domestic demand and exports (Figures 12 and 13).

Since the beginning of the last decade, and only interrupted by the financial crisis, German exports have always grown faster than French exports (Figure 13). In other words, in view of the roughly equal growth performance overall, Germany was increasingly dependent on foreign economic activity, which also caused the much stronger slump during the financial crisis. Conversely, this also explains the stronger impetus from the global recovery after this crisis. This can be seen as a global demand effect that benefited the German economy primarily because of its high share of capital goods during the global upswing (Horn and Lindner 2016). In terms of comparison with the French economy, this would be an unproblematic result that would merely reflect a different economic structure with advantages and disadvantages for the two economies depending on the relevant global economic situation.

However, the high level of exports combined with concisely weak domestic demand is also the result of a supply policy based on the narrative described above. This was by no means neutral with regard to the French economic situation, but damaged it. This applies until the financial crisis. After that, there was a break with this economic policy strategy, which had a very positive effect

Real GDP and domestic demand

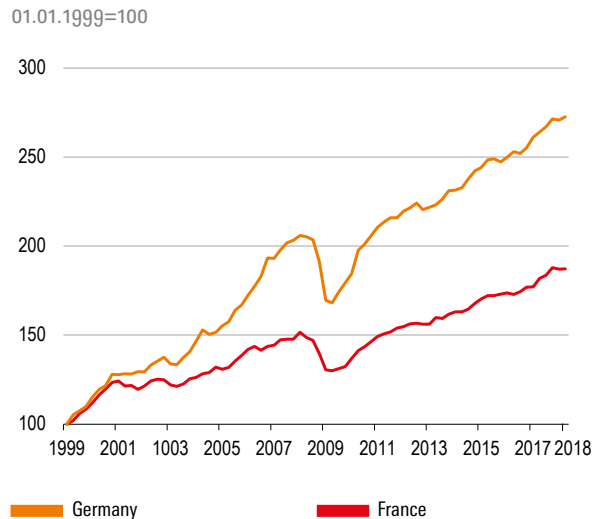


Sources: OECD; Macrobond.

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Figure 13

Export development since the beginning of monetary union



Sources: OECD; Macrobond.

IMK

on Germany, but without being of sufficient help for the French economy so far.

In essence, there are two reasons for the relatively positive employment trend since the financial market crisis in Germany. The first is that Germany coped much better with the economic slump in the wake of the financial crisis

Figure 14

than France, thanks to stabilising measures, especially on the labour market. The second reason is a much more balanced upturn in domestic and foreign trade since the financial crisis, in which, unlike in previous upturns, private consumption also plays a decisive role and not just exports.

This is about price competitiveness, which is closely linked to unit labour costs, i.e. the ratio of wages to productivity. The initial focus will be on nominal wage developments in both countries. Significant differences can be seen here. About two years after the start of monetary union, German and French wage trends have decoupled (**Figure 14**). While wage developments in France followed a steady upward path, they weakened significantly in Germany in the past decade. At times, wages per hour even declined slightly. This was the result not only of the labour market reforms of that time, but also of the long-standing pressure on the wage formation process (Dustmann et al. 2014). It was, in a way, an economic expression of the narrative of Germany's lack of competitiveness that prevailed at the time, the recovery of which would require noticeable reductions in wage costs.

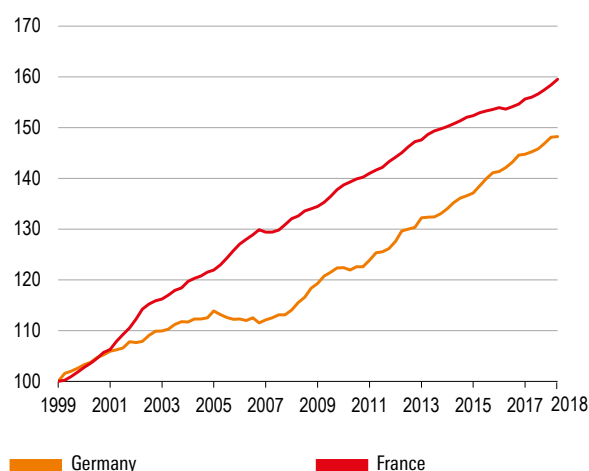
From a German perspective, this strategy initially appeared successful. Until the middle of the last decade, productivity development in the two countries was not very different. In the upswing immediately before the financial crisis, however, the French economy showed weaknesses. Since then, productivity has risen more slowly in France than in Germany, where it continues to rise at an almost undiminished rate (**Figure 6**).

With this combination of weak wage and trend productivity performance in Germany and trend wage and relatively weaker productivity performance in France, it was evident that the German economy had embarked on a markedly lower unit labour cost path than France. Germany also lagged far behind the euro area as a whole in terms of wage costs until the financial crisis (**Figure 15**). This then resulted in correspondingly lower inflation. In other words, Germany gained in price competitiveness; as a result, German exports were correspondingly strong and domestic demand correspondingly weak.

Contrary to what is often described in public discourse, because of the weakness of domestic demand, which reduces employment, this is not at all a success story; certainly not from the point of view of the euro area as a whole and France in particular. For France it was a heavy burden

Nominal hourly wages

01.01.1999=100



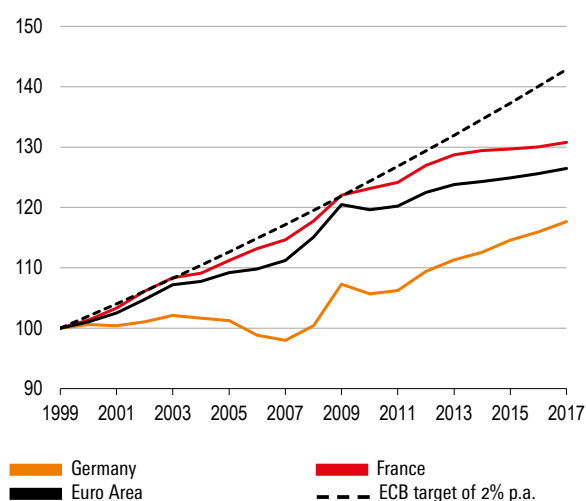
Sources: ECB; Macrobond.

IMK

Figure 15

unit labour costs

1999=100



Sources: Eurostat; Macrobond.

IMK

(Horn et al. 2005). After all, this is a strategy of real devaluation within the euro area. This was not a problem if there had previously been an overvaluation that had to be corrected. If this is not the case, however, frictions of a destabilizing devaluation race within the common currency area are inevitable. This is seen by many as threatening the very existence of the single currency. This problem has been pointed out in

many places in recent years (Eichengreen 2010; Storm and Nastaapaad 2014; Stiglitz 2016). These studies are based on the premise that such a correction would not have been necessary in the case of Germany, or at most to a much lesser extent. There is indeed much to be said for this. Germany's current account deficit at the start of monetary union, for example, was not of a worrying magnitude, especially if one considers the subsequent current account surpluses, which were far more substantial in quantitative and qualitative terms (Figure 16).

At the same time, neither inflation nor unit labour cost developments in Germany indicate a cost problem and thus a competitiveness problem. Against this background, the real devaluation was misguided. The recourse to earlier, actually considerable cost increases in the context of German reunification is not helpful either. The currency changeover from DM to Euro took account of those cost differences, which were certainly present at the time. This was also reflected in the beginning reduction of the current account deficit. Germany's current account balance was already in balance again in 2001. The only remaining argument of the proponents of a real

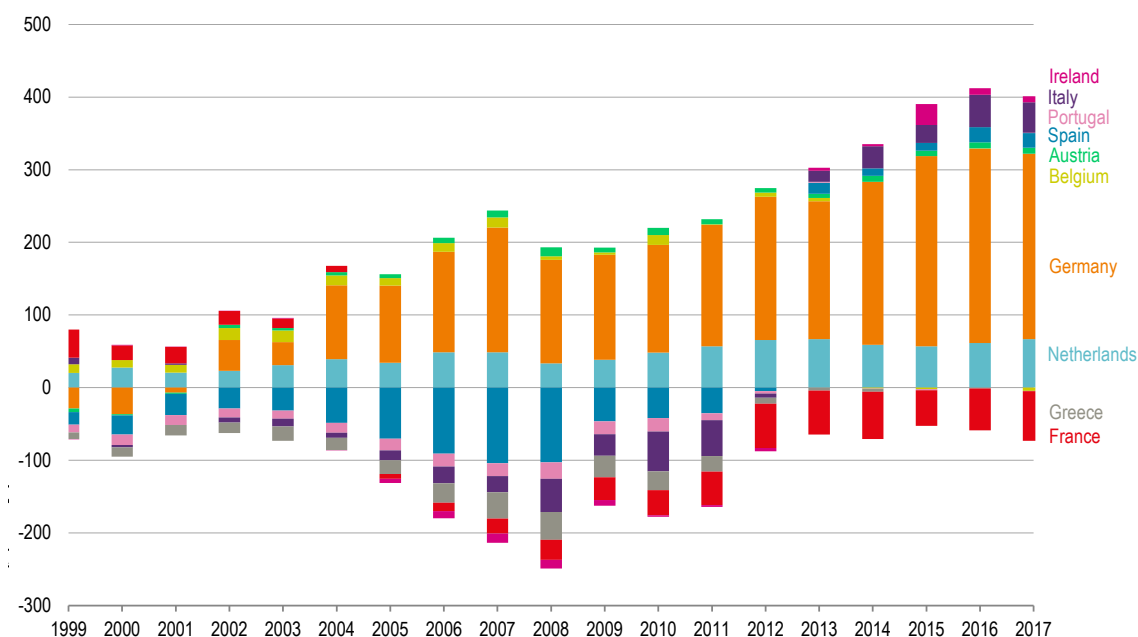
devaluation strategy was the high level of unemployment in Germany at the time, both in absolute terms and in comparison with France.

A SECRET PARADIGM SHIFT IN GERMANY AND A PUBLIC ONE IN FRANCE

Since the financial crisis, and especially in the phase of immediate recovery, the German economy has developed a noticeable lead. This is remarkable in that productivity in Germany fell drastically during the financial market crisis, while it fell comparatively little in France. Here lies an important feature of the German economy compared to the French economy. It is about external versus internal flexibility. The former refers to the ability to react quickly to economic crises by laying off workers. The latter, on the other hand, refers to the rapid reduction of working hours during periods of weakness. The former shifts the consequences of the crisis to the external labour market (Horn et al. 2013). The latter leaves them internally within the company. As a

Figure 16

Current account balances of euro area countries in EUR billion



Sources: Macrobond (AMECO); IMK calculations (Data status 13.03.2018).

result, in the first case productivity development is only slightly affected, while in the second it comes under strong pressure.

What appears to be a burden from the point of view of productivity is a clear advantage from the point of view of employment development. This has to do with the economic stabilisation effect of such flexibility. Despite the massive slump in production, employment has been maintained. As a result, income development also remained relatively stable. This in turn led to a comparatively stable development in consumption, unlike observed in other economies during this period.

With the successful stimulation of consumption as a stabilization policy, economic policy in Germany realigned itself without being the subject of much public debate. Whilst in the previous decade, efforts to increase price competitiveness by exerting pressure on wages through labour market reforms and thus to increase exports were at the center of policy making, now the implicit goal was to strengthen domestic demand. From this perspective, wage increases no longer appear as a threat to economic activity, but as its drivers. With higher real wages, the consumption opportunities of private households are expanding. This leads to increased domestic demand with higher employment and higher government revenues. These effects are not just the product of theoretical considerations, but have been observed in Germany year after year since 2011. This virtuous circle works as long as wage increases do not jeopardize price competitiveness, which is currently not the case in Germany.

This change in strategy, as well as the stabilisation measures incompatible with the previously dominant neo-liberal ideas, has never been the subject of a significant public economic policy discourse in Germany. It took place, in a way, below the radar of public attention. This explains

why the narrative of employment growth thanks to the creative power of neoliberal labour market reforms still dominates public debates, even though it has little to do with the current economic reality.

This part of the public discourse, however, is well perceived in France. For this reason, labour market reforms in Germany are often seen as a model for France to achieve the same growth path as the German economy (DIW 2017, FAZ 2017). In France, a controversial public debate has unfolded on this issue. And indeed, a change in the balance of power on the labour market at the expense of the trade unions could lead to noticeably weaker wage increases. This is not only superfluous, as shown above, but also harmful. In this way, wages in Germany and the rest of the monetary union would come under renewed pressure. There would be a danger of further internal devaluation rounds, which would ultimately burden overall economic demand and thus growth, employment and price stability throughout the euro zone. But this danger can be averted if the French President's macroeconomic ideas for monetary union are implemented and his labour market reforms in France maintain the balance of power on the labour market. It would be useful if internal flexibility could be strengthened in the French labour market in the form of more variable working hours. This would help to increase the absorption capacity of the labour market.

In Germany, on the other hand, the chosen path should be consistently pursued. In particular, expansionary fiscal and wage policies should bring inflation back to the ECB's target line. Only once this has been achieved should the pace of wages and government spending be slowed down again.

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