QUAND LA FRANCE S’ÉVEILLERA

WHEN FRANCE WAKES UP
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Introduction:

Reforms are overdue
Seven years on from the start of the financial crisis and continental Europe is struggling with weak growth. France has been particularly slow to acknowledge its structural problems. Yet it maintains the ingredients for economic success and the outlook is bright if its government gets to work on the reforms it so badly needs. As other countries also begin the slow road to recovery, we assess the implications for investing in European assets.

In January 2012, credit rating agency S&P downgraded the sovereign debt ratings of several European countries, including France. A few months later we published an EMEA Perspectives in which we concluded that France needed to “address its structural issues and deal with its entrenched lack of competitiveness and high level of unemployment”.

Two-and-a-half years later we are revisiting the issue at a time when France is commonly perceived to have become one of the Eurozone’s weakest nations. We believe France is overburdened fiscally, overprotected socially and overregulated commercially. As a result, economic growth is weak, fiscal deficits and public debts are high, and unemployment is structurally elevated. France has significant comparative advantages and can boast plenty of globally competitive companies. Yet there is an urgent need for the government to accelerate and broaden its efforts to implement a comprehensive reform program and a credible medium-term fiscal policy.

“We believe France is overburdened fiscally, overprotected socially and overregulated commercially. As a result, economic growth is weak, fiscal deficits and public debts are high, and unemployment is structurally elevated.”
Government spending is out of control
Government spending is out of control

Fiscally overburdened. In 2013 French government spending reached 57% of annual Gross Domestic Product (GDP) or €1,175 billion. This number is notable for the following reasons:

- It has increased by 5% of annual GDP since 2000.
- It is the highest since records began in the early 1950s.
- It is 7% higher than the Eurozone average and 12% higher than Germany and the Organisation for Economic Co-operation and Development (OECD) average.

Chart 1: France is Europe’s biggest spender
Expenditure breakdown as percent of GDP, FY 2013

• The French state spends more than other countries in the Eurozone owing largely to how much it pays government employees and its social security bill (see chart 1).

- According to 2011 figures, the government employs 22% of the country’s labor force compared with the OECD average of 15.5%. Notably, OECD surveys of central government salaries reveal that France pays 10% to 40% more than the OECD average (adjusted for currency purchasing power parity).

- Meanwhile, social security spending is equal to one quarter of the country’s annual GDP, according to Eurostat.

One consequence of the need to control the budget deficit is that France’s tax burden is high and rising (see chart 2). In 2013 annual government revenues were 53% of GDP, which is 6% higher than the Eurozone average and 8% higher than Germany. Taxes and social security contributions are both 3% higher than the Eurozone average.

![Chart 2: France’s tax burden is the highest in the Eurozone](source: Eurostat, J.P. Morgan Private Bank, August 2014)
In particular, French employers suffer a significant disadvantage due to the amount they must contribute to the country's social security budget (see chart 3). For every €100 an employee earns in gross salary, their company pays an additional €40 in social contributions, the highest among OECD countries. As a result of these charges, French companies are reluctant to hire full-time staff, which contributes significantly to the high unemployment rate.

Chart 3: French companies have the highest social security burden within the OECD

Average single worker without children. Percent. Employer SSC: incl. payroll taxes where applicable. Assumes a starting point of 100%, representing gross salary.

Time to cut the red tape
Socially overprotected. The French enjoy extensive and generous state-funded social security protection from the cradle to the grave. France spends 26% of GDP on social benefits, which is 2.5% more than the Eurozone average. Additionally, France has one of the world’s highest minimum wages at €1,445 a month (see chart 4). This figure is also one of the highest relative to the mean average wage for full-time workers (see chart 5).

Chart 4: France has one of the world’s highest minimum wages

<table>
<thead>
<tr>
<th>Year</th>
<th>France</th>
<th>Portugal</th>
<th>Spain</th>
<th>United States</th>
<th>Greece</th>
<th>United Kingdom</th>
</tr>
</thead>
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<tr>
<td>2002</td>
<td>600</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>2004</td>
<td>800</td>
<td>500</td>
<td>400</td>
<td>300</td>
<td>150</td>
<td>75</td>
</tr>
<tr>
<td>2006</td>
<td>1000</td>
<td>600</td>
<td>500</td>
<td>400</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>2008</td>
<td>1200</td>
<td>800</td>
<td>600</td>
<td>500</td>
<td>250</td>
<td>125</td>
</tr>
<tr>
<td>2010</td>
<td>1400</td>
<td>1000</td>
<td>800</td>
<td>600</td>
<td>300</td>
<td>150</td>
</tr>
<tr>
<td>2012</td>
<td>1600</td>
<td>1200</td>
<td>1000</td>
<td>800</td>
<td>350</td>
<td>175</td>
</tr>
</tbody>
</table>


France spends around half of its total social security budget on pensions, which is generous on an international basis. The OECD calculates that France’s replacement rate stands at 59% of the average worker’s income compared with 54% for the OECD and only 42% in Germany.

In addition, French workers retire earlier than their international counterparts. As a result, government spending on retirement benefits is 2% of GDP above the Eurozone average despite favorable demographics. That is why pension reform is so important.
Chart 5: The minimum wage is also one of the highest relative to average salaries

Mean average of full-time workers, 2012

- France
- Ireland
- Belgium
- Portugal
- United Kingdom
- Spain
- Japan
- Greece
- United States


Commercially overregulated. Unnecessarily rigid regulations stifle the efforts of France’s established businesses and entrepreneurs on a daily basis, making them less efficient. The problems are particularly significant in the labor market, where the laws contribute to the persistently high unemployment rate. The result is to increase the cost of doing business and the discount rate applied to any investment decisions in France.
For example:

- The Labor Code runs to more than 3,500 pages.
- France is ranked 144 out of 148 countries by the 2013 World Economic Forum for its “hiring and firing practices”. Its rivals at the bottom of this ranking include Venezuela, Zimbabwe, South Africa and Italy.
- It is easy for employees to contest a dismissal in court, creating complex, costly and uncertain situations for employers. As a result, companies take a long time to hire permanent employees (see chart 6).

Chart 6: France has one of the highest employment protection schemes

2013 data; scale 0-6. Contribution of employment protection for regular workers against individual dismissal (EPR) and additional provisions for collective dismissal (EPRC) to the indicator of employment protection for regular workers against individual and collective dismissal (EPRC). The height of the bar represents the value of the EPRC indicator.
A country in decline?
A long period of decline. Following several decades of misguided policies, France’s fiscal deficit and public debt have increased steadily, unemployment remains stubbornly high, the pace of economic growth has fallen and the country’s businesses have become less competitive. Unit labor cost figures reveal that France has lost 20% in competitiveness relative to Germany since 2000 (see chart 7 & 8).

The causes include the introduction of the 35-hour working week in France, in early 2000, and the ambitious reforms implemented in Germany’s Agenda 2010 between 2003 and 2005. France has also lost competitiveness against the peripheral countries that have implemented reforms since 2009, such as Greece, Ireland, Portugal and Spain.

Chart 7: Real unit labor costs across Europe

Index, Q1 2000=100

Chart 8: France has become less competitive relative to Germany

Germany / France relative unit labor costs. Index ratio

Chart 9 shows a steadily deteriorating trade deficit since 2005, driven by growth in imports outpacing exports. Since the turn of the century, France has lost market share in world trade at a faster pace than most advanced economies.
A country in decline?

In early 2014, after almost two years in power, President Francois Hollande announced a policy U-turn. Instead of increasing taxes and spending, both would be reduced with tax cuts focused on business. This new direction was confirmed in late March when Manuel Valls became Prime Minister.

The government plans to reduce business labor costs and taxes by €40 billion between 2015 and 2017. Staggered over these three years, the plans include a decrease in employers’ social contributions for lower-wage earners, a reduction in Corporate Income Tax (CIT, currently 33%), and the abolition of both the surcharge on CIT (11% over the 33%) and an additional corporate tax on revenues.

The cuts in social security contributions represent about 4% of total labor costs for businesses (gross wages plus employers’ contributions). These cuts will be financed by spending reductions across all layers of government.

This new policy is being implemented slowly owing to stiff resistance from core supporters of the Socialist Party. To strengthen the government’s resolve, a reshuffle took place recently in which the three left-wing ministers who had criticized this new direction were sacked and Emmanuel Macron was appointed as the new Economy Minister.

How is the government reacting?

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Chart 10: Have the French lost faith in the ability of their politicians?

Public confidence in the government’s ability to tackle various challenges. How confident are you that the government will achieve its objectives with respect to...

<table>
<thead>
<tr>
<th></th>
<th>Quite confident</th>
<th>Not confident</th>
<th>Total</th>
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<tr>
<td>Budget deficit reduction</td>
<td>18%</td>
<td>82%</td>
<td>100%</td>
</tr>
<tr>
<td>Economic growth</td>
<td>16%</td>
<td>84%</td>
<td>100%</td>
</tr>
<tr>
<td>Reducing unemployment</td>
<td>15%</td>
<td>85%</td>
<td>100%</td>
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In our opinion, the French government should accelerate, deepen and broaden its reforms. There are two main reasons:

1. It has little to lose: only 15% to 18% of the population trust its ability to meet the challenges of unemployment, public deficit and economic growth (see chart 10).

2. The reforms are a step in the right direction but they are far from sufficient. For example, cutting public spending by €50 billion in three years (2015 to 2017) amounts to 0.8% of annual GDP. At this pace, it would take France 15 years to lower its public spending to the German level.
Risks and opportunities for investors
Risks and opportunities for investors

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The international financial environment remains favorable: liquidity is abundant and should increase if the European Central Bank (ECB) extends its initial asset purchase program. Meanwhile, government bond yields are at a record low (just 1.25% in France) and the euro is depreciating. Germany remains in good shape, Italy is beginning to reform and peripheral countries are recovering. Driven by the US, growth in the rest of the world is solidifying. Against this positive backdrop, France should find it less painful to implement reforms.

In Brussels and in Frankfurt, there is also growing recognition that fiscal austerity must be accompanied by stimulus measures, possibly financed by the EU in order to mitigate the costs to individual countries. We believe the deeper the reforms, the stronger the support should be from Europe. These stimulus measures could include tax cuts, greater public investments, or targeted sectoral plans.

Public French companies remain competitive and profitable despite the domestic environment in which they operate. They have diversified internationally: for the benchmark French stock market index CAC 40 companies domestic sales make up just a third of the total.

Should investors be concerned?

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Chart 11: French businesses have diversified into international markets

CAC40 Index: sales exposure. Percent of sales

- Domestic: 34%
- Europe (ex-dom): 28%
- Americas: 13%
- Emerging Markets: 9%
- Asia: 8%
- Others: 8%


These factors help us to maintain a positive view on European risk assets including equities and allow us to be patient in our assessment of France. In our diversified, managed portfolios we have maintained an allocation to European equities and to periphery small and mid caps. On a tactical basis, we see opportunities among European large cap exporters. For longer-term investments, Europe’s economic and financial background is favorable for targeted private equity investments.
A brighter outlook?

France has some significant competitive advantages and has no reason to fear a more flexible domestic environment or intense international competition. The country is still ranked among the top 25 by the World Economic Forum (out of 148), which highlights the quality of its infrastructure, the size of its market (a GDP of $2.75 trillion, the world’s fifth largest), its technological readiness, its innovation and its business sophistication. France enjoys strong agricultural and tourist industries. According to the World Tourism Organisation, France welcomed 85 million foreign tourists in 2013 and the industry employs 11% of the workforce. We believe that, with more flexible working and regulatory practices, France has the potential to revive its economy by creating new jobs and business opportunities.

“We believe the deeper the reforms, the stronger the support should be from Europe.”
César Pérez is Chief Investment Strategist for Europe, the Middle East, and Africa (EMEA) and a member of the Global Investment Committee. César has worked in investment management across all asset classes and regions for both institutional and private clients for the past 20 years, including two years at Credit Suisse Asset Management as head of equities, five years at M&G Investments in London and nine years at J.P. Morgan Investment Management in Madrid, London and New York.

César’s interviews have appeared in the Financial Times, Les Echos, Il Sole, La Stampa and Reuters, among others. César specialized in management and industrial organization at Instituto Católico de Artes e Industrias.
Olivier Lemaigre is Investment Strategist for Europe, the Middle East, and Africa in the Office of the Chief Investment Strategist of J.P. Morgan’s Private Bank. Based in London, Olivier is responsible for monitoring top-down and market developments across European time-zone assets and generating their investment implications.

Previously, Olivier spent more than 20 years in the United States working for Legg Mason and Citigroup Asset Management as a top-down strategist in the Emerging Markets Equities team, and for Citicorp Securities as a sell-side Latin American Economist and Emerging Markets Debt Strategist.

Olivier graduated from the John Hopkins’ School of Advanced International Studies (SAIS) and from the University of Pennsylvania’s Wharton School of Business.
Frances Rhodius

Frances Rhodius is an Associate on the J.P. Morgan Private Bank Investment Strategy team based in London; covering Europe, the Middle East, and Africa. Frances focuses on economic and financial market analysis as well as asset allocation and portfolio strategy.

Prior to joining the Investment Strategy team, Frances was an analyst for the Latin American team in Geneva and worked at BNP Paribas Arbitrage in the Global Equities and Commodity Derivatives department in Paris.

Frances holds a double degree in BSc International Management and Modern Languages from the University of Bath, and completed her exchange at l’ESCP Europe in Paris.
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