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Productivity and competitiveness in the euro area: A view from France

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In September 2016, the European Council invited all euro area members to set up a National Productivity Board to focus on productivity and competitiveness. This column summarises the main findings of the first report of the Conseil National de Productivité, which analyses the causes of the French productivity slowdown that are common to other OECD countries and those that are specific to France. It also proposes a definition of competitiveness that should be useful for euro area macroeconomic policy debates and explains why current account imbalances in the euro area are both a sign of deficient adjustment mechanisms and a cause of concern.

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In September 2016, the European Council invited all EU member states sharing the euro to set up a National Productivity Board (NPB) whose objective is to offer a diagnosis and analysis that “spans a comprehensive notion of productivity and competitiveness” according to the Council Recommendation (European Council 2016). The French NPB whose members are independent economists just published its first report (French National Productivity Board 2019) which attempts to establish a diagnosis focused on France, but which also highlights the particular dimension that competitiveness takes in a monetary union.

The birth of NPBs is an interesting story in itself as it summarises some of the deep economic disagreements on the issues facing the euro area. A note of the French Council of Economic Analysis (Benassy-Quéré and Ragot 2015) recommended to “establish an independent council for Competitiveness and Social Dialogue at Member State level” which became Competitiveness Authorities in the Five Presidents’ Report (Juncker et al. 2015) and finally morphed into National Productivity Boards in the Council recommendation. This was a typically Franco-German compromise reflecting two opposite narratives: productivity (to push for structural reforms) was in the title, but competitiveness (to push for policies to reduce macroeconomic imbalances in the euro area) was explicitly in the text of the Council recommendation. Constructive ambiguity was also at work in a typical European manner, as the two terms were not clearly defined and differentiated and so were left to the interpretation of the boards.

The French NPB took it from there and decided to take a stand on how we should define, measure and interpret the productivity and competitiveness concepts which we think are related but different. We also emphasise that productivity and competitiveness are not redundant and that policymakers should not confuse the two. For instance, with similar productivity profiles, France and Germany have very different performances with regards to their competitiveness as measured by their current account (Figure 1).

It is worth noting that while economists are broadly at ease defining and even – although with some well-known challenges – measuring productivity, there is less consensus on competitiveness at the country level and whether it takes a special dimension in the euro area.

In the French National Productivity Board’s first report, competitiveness is summed up in the level of the current account relative to a norm. This norm is defined for each country by factoring in some structural factors such as demography and the net external investment position (Cubeddu et al. 2019). Analysing its different detailed components (merchandise trade balance, services including items like tourism or intellectual property incomes, net investment revenues, etc.) and the



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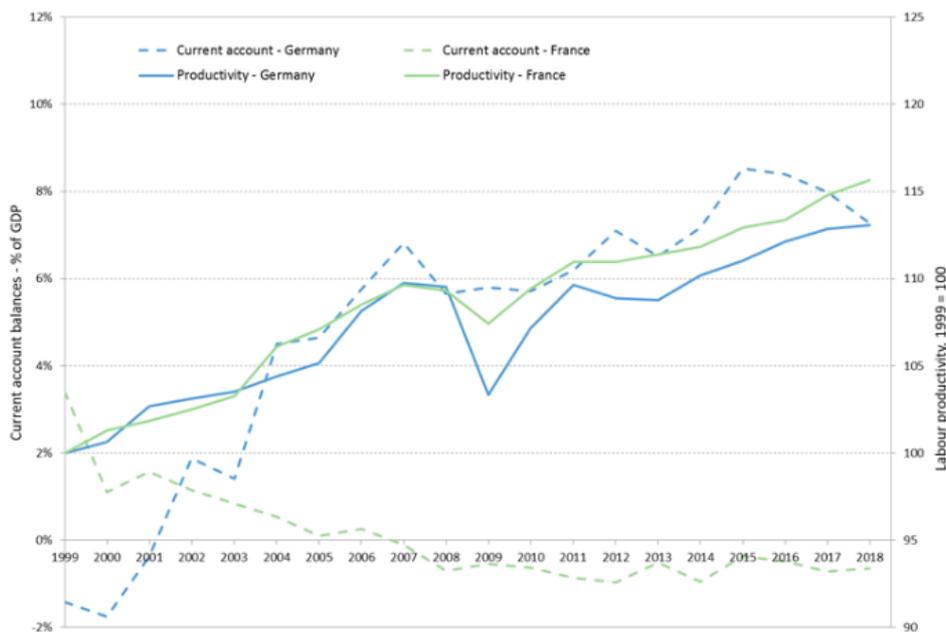
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factors behind them, such as market share evolutions, allows for a more granular and disaggregated understanding of a country's main competitiveness components, strengths, and weaknesses. In this way, we hope to capture the causes of competitiveness gaps and identify policy recommendations to resort them.

The French NPB endorses the viewpoint of the Macroeconomic Imbalances Procedure: monitoring of competitiveness is a key issue in the euro area because the accumulation of external imbalances can, in the absence of exchange rate adjustments, lead to a balance of payments crisis and eventually to redenomination risk as experienced during the euro crisis. Conversely, excessive current account surpluses can reflect internal structural imbalances, complicating adjustment policy mechanisms.

Figure 1 Labour productivity and current accounts in Germany and France



Source: Eurostat.

Note: Productivity is real labour productivity per employed worker, 100 in 1999. Currents accounts come directly from the balance of payments.

The productivity slowdown is mainly the result of common international trends

France's productivity, although it remains at a high level – similar to that of Germany – has slowed down since the late 1990s as in the rest of the OECD (Andrews et al. 2016, 2017). Our assessment is that the slowdown in productivity in France is mainly due to factors that are common to all developed countries. The main factors we emphasise are:

- The shift in the structure of production towards sectors with lower productivity levels, namely services as compared to industry. However, since the 2000s, it has rather been the productivity slowdown *within sectors* that has contributed to the overall slowdown.
- The weakening contribution to growth of information and communication technologies (ICTs) since the early 2000s. This is primarily due to the slowdown of technological progress within the ICT sector itself, but it may also reflect the slow implementation of the productivity enhancing organisational change complementary to these new technologies and the worsening of the reallocation of activity towards firms that are best able to use them.
- The increase in productivity dispersion between firms especially in less knowledge intensive services. Productivity growth has been weaker within industries displaying the largest divergences in productivity. This may reflect a poor allocation of resources between firms. A weakening of technological diffusion, which could be due to a growing difficulty in harnessing technological progress, may be part of the explanation for this increasing divergence.

A specific weakness in France: Skills of the workforce

The French productivity slowdown may also be linked to factors that are specific to France and that should be a source of policy concern. First, we emphasise the fact that skills of the French workforce have been falling below the OECD average (OECD 2016). This is particularly problematic given the growing skills requirements related to technological change. The French education



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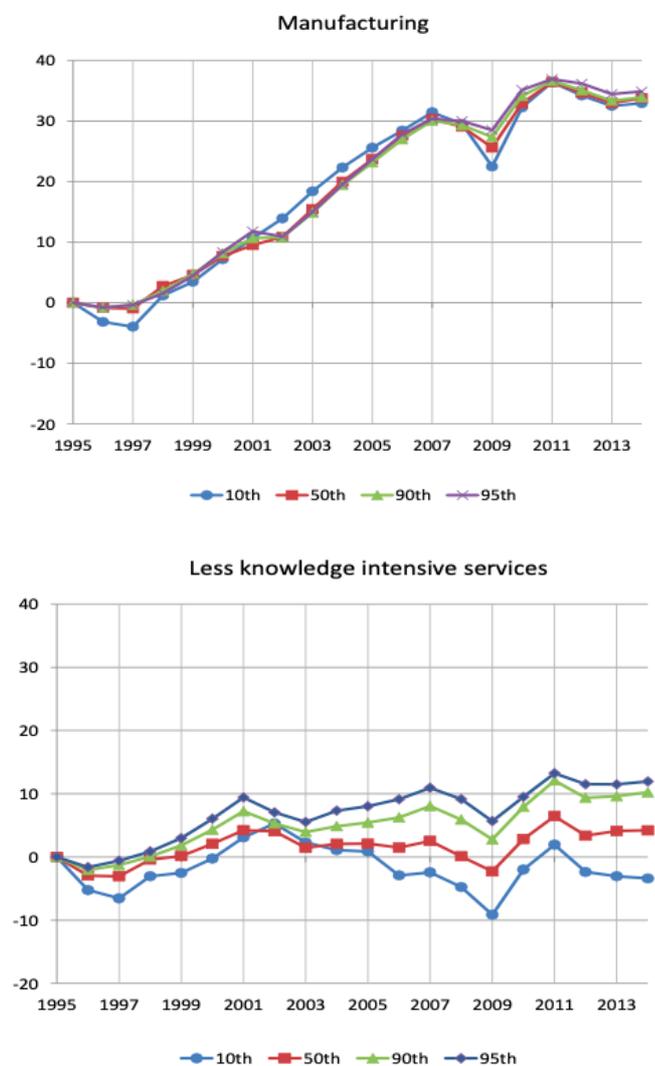


system is characterised by a greater skills gap between people from different social backgrounds relative to other countries. Adult skills are lower than the average of the countries participating in the OECD surveys. In addition, those skills appear to decline over the working life, in particular due to a lack of lifelong learning opportunities which is particularly prevalent among the most vulnerable employees. France also lags behind other countries in terms of soft skills (Algan et al. 2018).

Second, the French production system may have some characteristics that are likely to hinder productivity especially in low-skilled services. In France, the gap between firms at the technological frontier and the rest is more pronounced for less knowledge intensive services (Figure 2). This suggests (but more research is required) that France may suffer from a deficient allocation of resources in these sectors that hinders its productivity growth and/or that 'best practice' spreads more slowly in these sectors.

Finally, low-skilled workers have a particularly low level of employment and policies put in place to increase employment may therefore temporarily reduce the productivity growth rate. Bourlès et al. (2012) estimate that were France to align its employment rate to the level of Germany (an increase of 8 percentage points), the level of labour productivity would fall by around 4 percentage points. This is not negligible, but this suggests that the high labour productivity level in France cannot be fully explained by this selection effect.

Figure 2 Labour productivity in France for different percentiles of the distribution



Source: MultiProd, OECD (see Berlingieri et al., 2017)

Note: Estimated year dummies of a panel-data regression of the relevant quantile of log labour productivity within industries in France, taking the first year as baseline

The modest French current account deficit hides a deficit in attractiveness as a manufacturing location

In the report, we assess competitiveness on the basis of the current account relative to a norm we take from the IMF to be around +1% for France. The French current account balance



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worsened in the early 2000s along with export markets shares and then stabilised. In 2018, the deficit was modest at -0.3% of GDP, but France is the only euro area country with a current account deficit and it may deteriorate if the euro were to appreciate. This number hides a large trade deficit – which reflects a negative trade balance in goods – partly offset by a surplus in net income from foreign investment. France distinguishes itself within the euro area by the prominence of its multinationals, which has increased further after the crisis (Emlinger et al. 2019). The combination of a surplus in the income balance and a trade deficit in goods suggests that France remains an attractive location for activities related to innovation and design, while its attractiveness as a location for manufacturing has worsened. In this sense, its modest current account deficit hides a larger deficit in attractiveness as a manufacturing location for tradable goods. Our assessment is that while cost competitiveness has improved since 2010 it remains fragile in particular due to high wage growth in (non-tradable) service sectors that can affect downstream manufacturing. Non-price competitiveness also remains (especially relative to Germany) a challenge for the French industry. In addition, one unique characteristic of the French tax system, namely high taxes on production, especially on turnover that are transmitted and amplified throughout the production chain, acts as a tax on exports (Martin and Trannoy 2019). More generally, France has also been late in implementing structural reforms – in particular on the labour market but also on education and public spending – relatively to some other European countries that were hit harder by the crisis.

Current account imbalances in the euro area point to deficient adjustment mechanisms

Competitiveness differential are not only national issues but more largely a Euro area issue. There are two apparently very different ways to analyse movements in current account balances: as the result of changes in the difference between 1) exports and imports, and 2) savings and investment. Some observers think in terms of the former, some in terms of the second and both talk past each other. Both approaches however have to hold because they are the two sides of the same coin, and forcing oneself to tell the story both ways is essential to identify the initial source of the problem: shifts to saving, shifts to investment, increases in productivity relative to wages, overheating, and so on. This is also essential for policy implications.

In France, the current account deficit was initiated by an increased public deficit and higher corporate investment before the crisis; while the post-crisis stabilisation reflects a reduction in the public deficit in tandem with private disinvestment. In Germany, the initial impulse was the low wage growth of the 2000s that led to an increase in exports and a large current surplus. This could have led to overheating were it not for fiscal consolidation and the resulting decrease in domestic demand. The increase in public saving came at the same time as increased corporate saving due to higher profits. This led to an excess of overall saving over investment. These trends were not fundamentally reversed after the crisis.

At the same time, peripheral countries were on an opposite trend. They experienced a boom in demand from the private or public sectors due to entry in the euro and the subsequent fall in interest rates and excess credit (Martin and Philippon 2017), which fuelled growth in unit labour costs, deteriorated their competitiveness and their current account balance.

This contrasted situation produced a balanced current account at the level of the euro area with important imbalances between countries within the area (see Figure 3). The crisis and the sudden stop in the financing of deficit countries forced a sharp adjustment which mostly took the form of tighter fiscal policy and lower demand rather than depreciation. The current account reversal was therefore attained through lower investment, wage adjustments and higher public savings. For its part, Germany maintained a tight fiscal policy without sufficiently adjusting wages, prices, and its current account surplus. This adjustment asymmetry has led to excessively low demand within the area, an increase in its surplus and deflationary pressures. This then contributed to a heavy use of expansionary monetary policy by the ECB, which contributes to an undervalued level of the euro and in turn reinforces the area's current account surpluses vis-à-vis the rest of the world.

In its latest external balance assessment,¹ the IMF considers the 3.5% euro area current account balance in 2017 to be above its "norm", which is estimated at 1.5% of GDP. This current account surplus hides larger imbalances, particularly surpluses of Germany and Netherlands of 7.3% and 12% of GDP, respectively (in 2018), which are a problematic issue particularly in a monetary union (Blanchard et al. 2011). Given that adjustments of imbalances within the euro area can no longer be achieved through nominal exchange rates, they must be achieved either through decreases in prices and wages in countries in deficit, or through increases in prices and wages in surplus countries. The aggregate imbalance of the euro area is due to the fact that the adjustment has almost entirely happened through the first mechanism.

Figure 3 Balance of current transactions with the rest of the world, relative to euro area GDP

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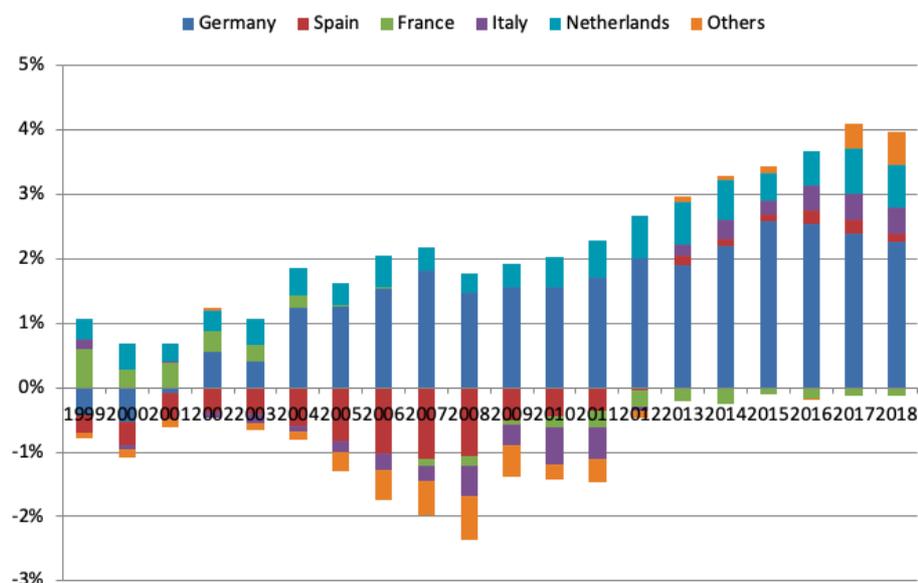
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Existing studies suggest that a gap of 2 percentage points in inflation rates between Germany and the rest of the euro area would be required in order to rebalance current accounts over a 10-year horizon (Gaulier et al. 2018). This is sizable and requires higher inflation in surplus countries, which in practice amounts to a real appreciation in these economies. This also means that the inflation target cannot and should not apply to all countries but to the average only. That prices and wages should grow faster in surplus countries of a monetary union constitutes the normal adjustment mechanism in market economies and this should be supported by economic policies. This could be achieved through a more expansionary fiscal policy for countries with surpluses and fiscal space in a persistent low interest rate environment and/or through increases in minimum wages. This would contribute to a rebalancing of savings and investment, as well as relative prices within the euro area. Germany and Netherlands rely too much, even from their own welfare point of view, on foreign demand rather than domestic demand. An appreciation following a more expansionary fiscal policy would be welfare improving for these countries. For countries with less fiscal space, higher inflation in surplus countries would allow for a real depreciation without deflation. This would allow for more reliance on foreign demand, less reliance on domestic demand, higher output, and would also be welfare improving.

Relying more on fiscal policy with more inflation in surplus countries would also help the ECB, which remains overburdened, towards monetary normalisation. This however should not exonerate countries – France in the first place – to put in place reforms to improve productivity and competitiveness.

More broadly, the dramatic adjustments that occurred after the crisis due to the mismanaged imbalances have shown the need for a thoughtful consideration of the required mechanisms to put in place in order to reduce those imbalances. Because, by accounting, a national current account deficit can only exist if partner countries are running a current account surplus, and that the accumulation of current account imbalances puts the eurozone at risk, we argue that the issue of competitiveness is a matter that should be discussed and addressed not only at the national level but also at the eurozone level.

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Endnotes

[1] <https://www.imf.org/external/np/res/eba/data.htm>

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