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Economic Research:

The Widening French Trade Deficit Exposes Its Structural Weaknesses

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Economic Research:

The Widening French Trade Deficit Exposes Its Structural Weaknesses

*(**Editor's Note:** This report is the latest in a biweekly series where S&P Global Ratings' economists examine economic and monetary developments in Europe, the Middle East, and Africa.)*

One notable weakness of the French economy is its external position. The trade balance has been chronically in deficit since 2002. Last year, the trade deficit widened again to €49 billion from €45 billion the previous year. The start of 2017 doesn't look promising either: the gap reached €25 billion for the first four months of the year alone (see chart 1).

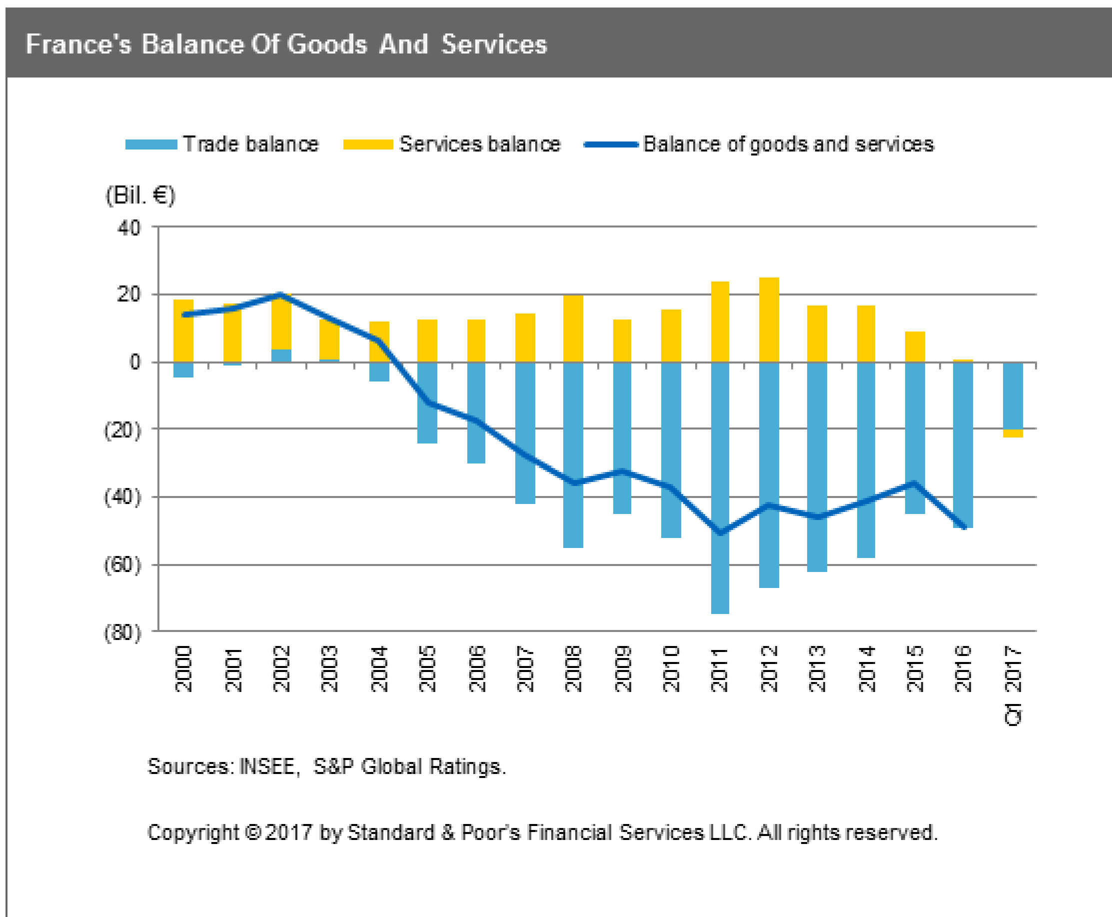
While the balance of goods improved between 2012 and 2015, this is primarily explained by exogenous factors. The weaker euro boosted exports in 2015, while lower oil prices helped to reduce the energy import bill. Indeed, the energy deficit halved to €29 billion from €66 billion between 2012 and 2016. By contrast, the trade deficit--excluding energy and military products--continued to widen over the same period, rising to €34.5 billion from €15 billion.

Overview

- In contrast with the trade positions of its main trading partners, France has run a trade deficit since 2002, which widened to €25 billion for the first four months of 2017.
- The country has seen its export market share fall more than for the rest of the eurozone. Since 2012, France has merely stabilized its position, while Spain and Germany have increased theirs.
- From a structural perspective, the insufficient competitiveness of domestic production underlies France's persistent trade imbalance.
- Thanks to "supply-side" measures to cut nonwage labor costs, profit margins for French companies have improved since 2014. Yet, the effects on investments and exports are likely to take more time to materialize.

Meanwhile, the services balance, which was in constant surplus, started to deteriorate in 2012 from €25 billion to €0.4 billion in 2016, then plunged into a deficit of €-2.7 billion in the first quarter of 2017. The primary cause: a fall in travel and tourism receipts in the past two years following terrorist attacks in France and since 2014 a surge in expenditures on visits abroad by French residents.

Chart 1

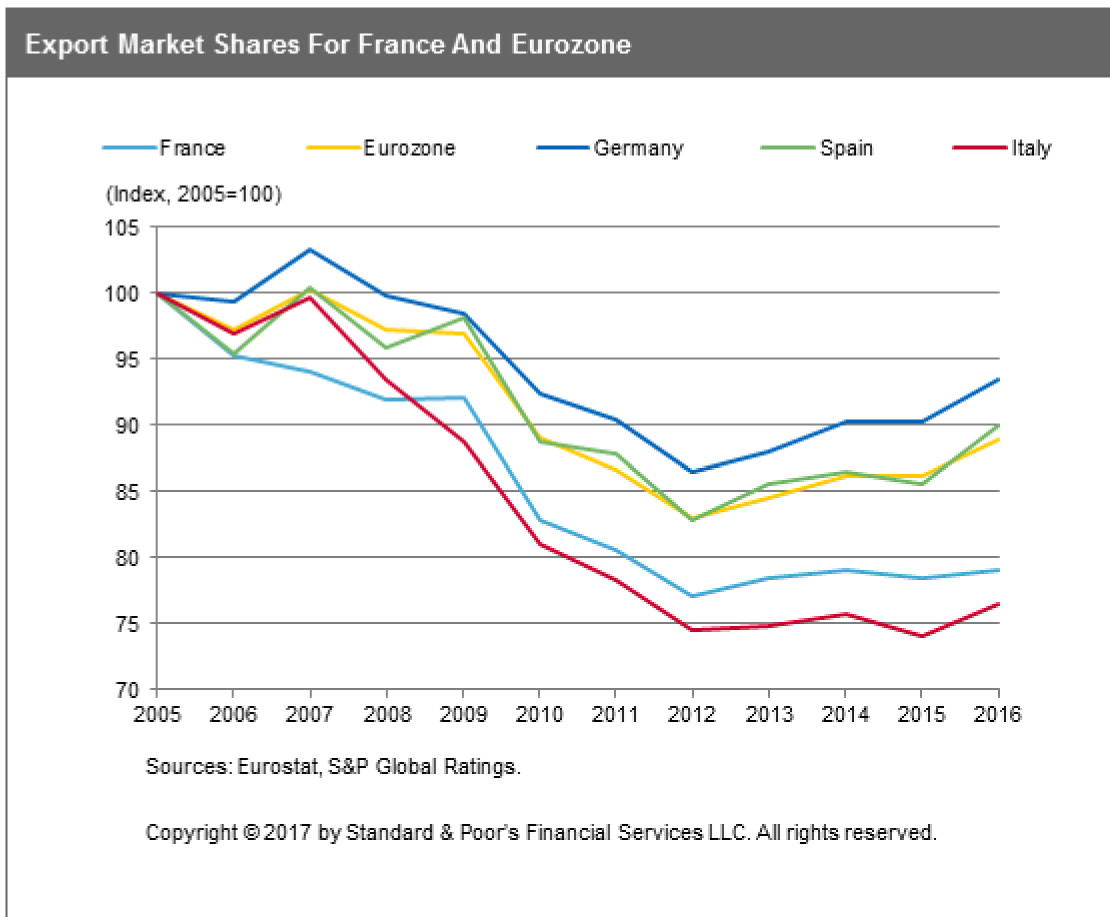


France's Industrial Fabric Fails To Meet Additional Demand

From a structural perspective, the insufficient competitiveness of French domestic production underlies the persistent trade imbalance. The country's export performance has been weaker than that of its major eurozone trading partners for years. Merchandise exports in volume by France have been growing by a feeble 2.4% a year between 2012 and 2016, compared with 2.7% for Italy, 3.0% for Germany, and 4.3% for Spain.

What's more, it appears like French firms have greater difficulty responding to an acceleration in global external demand than their foreign competitors. According to the export performance index, which compares a country's exports to global demand directed toward its exports, the French ratio sank between 2002 and 2009, before stabilizing somewhat. By contrast, German and Spanish indices rose, as their exports rose much faster than global demand, though only since 2009 for Spain. As a result, France has seen its export market share fall more than in the rest of the region on average (see chart 2). Since 2012, France has merely stabilized its position, unlike Germany, and Spain, which have seen their export market share recovering.

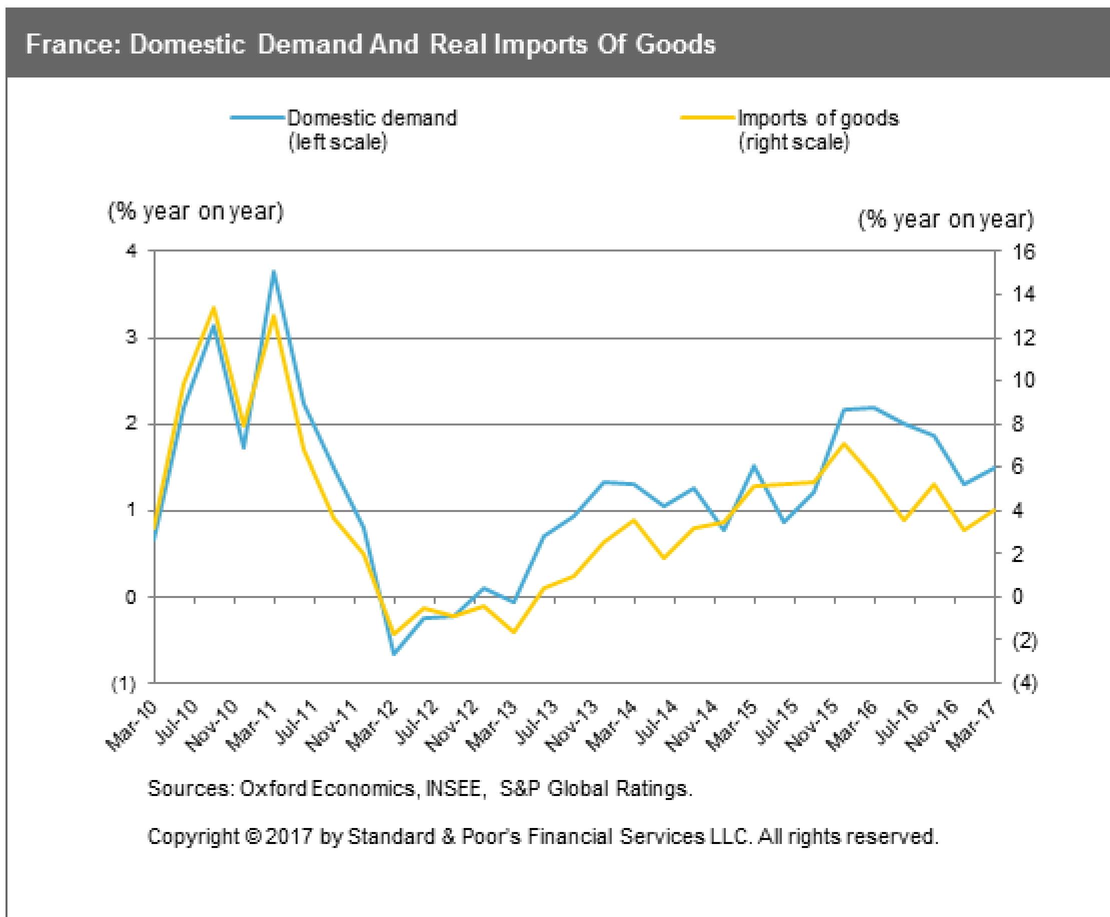
Chart 2



The deterioration in competitiveness also points to the relative inefficiency of French firms to service their domestic market. Indeed, real imports of goods in France have been rising faster than exports between 2013 and 2016 (3.4% versus 2.4%). In fact, the rise in imports has been associated with the acceleration in domestic demand on the back of increased purchasing power for households and a revival in the investment cycle (see chart 3). Meanwhile, industrial output growth has remained sluggish, growing by an average of 0.4% in the past there years and a meagre 0.6% in the first five months of this year compared with 2016 average output.

Trends in the French car market illustrate that point. In the first five months of this year, new car registrations surged by 7.8% and by 28% since the start of 2015. Meanwhile, the auto industry has seen its trade deficit widen to €9.7 billion in 2016 from €6.4 billion in 2015 as imports grew by 10.1% in 2016 and by 6.8% in the first four months of this year.

Chart 3



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Weaker Growth In Unit Labor Costs Improves Cost Competitiveness

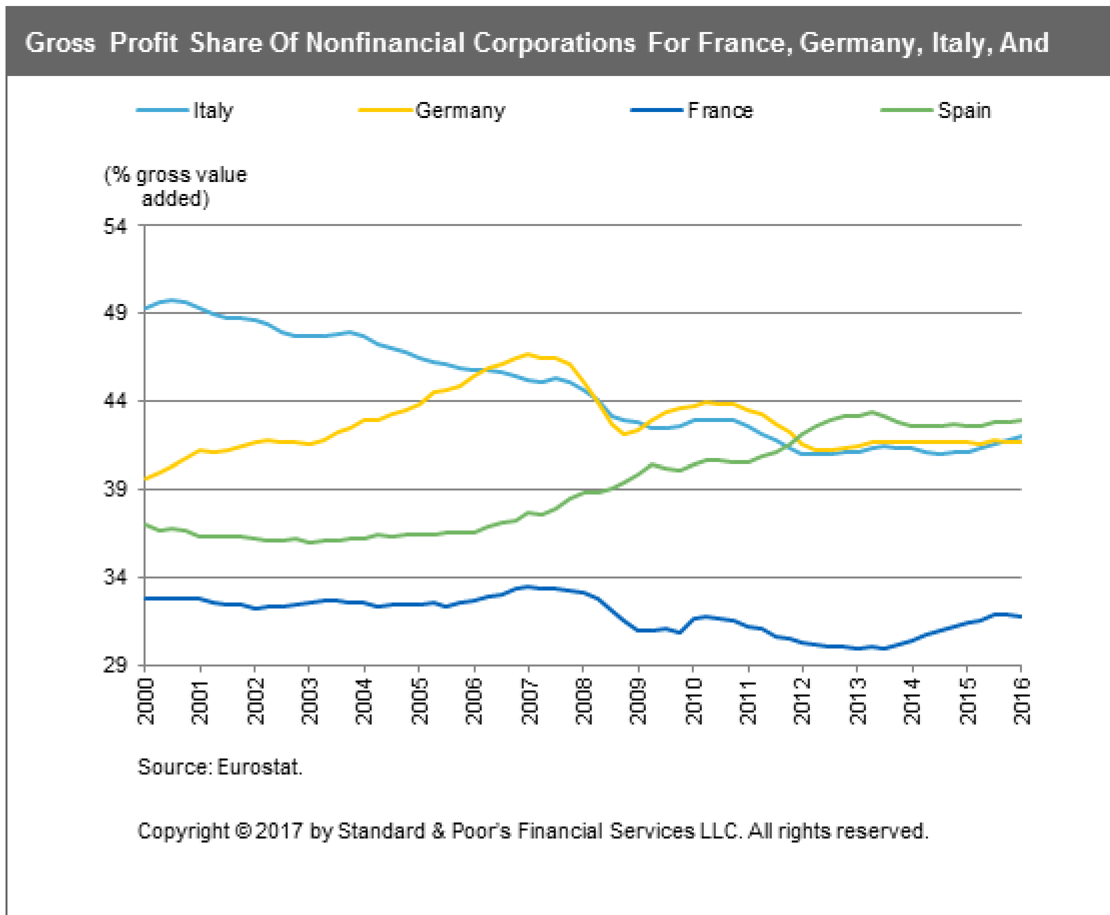
The French government implemented "supply-side" measures to cut nonwage labor costs since 2013, notably via the CICE (competitiveness and jobs tax credit) and cuts in employer social security contributions as part of the "Responsibility Pact." As a result, while growth in labor costs has been higher than productivity growth since 2000, it slowed sharply in 2015 and 2016 to only 0.3% and 0.6%, compared with an annual average 1.7% between 2009 and 2013. Growth in unit labor costs has also been slower than in Germany (at an average annual 0.3% versus 1.6% between 2013 and 2016), but faster than in Spain, where they have been falling (an average annual -0.2% over three years). Yet French unit labor costs have been 3.5% higher than the eurozone average since 2000, while Spain has completely closed the gap (down from 14.7% in 2008) and Germany's is 7% below the average.

Profit Margins, Still Low, Respond Positively

For now, the main effect of France's slower unit labor cost growth is on the profit margins of nonfinancial companies, which rose in 2014 for the first time since 2010, reaching 32% in 2016 from 30% in 2013. Yet, while in recovery,

French nonfinancial corporate profitability remains one of the lowest among the major EU economies (see chart 4).

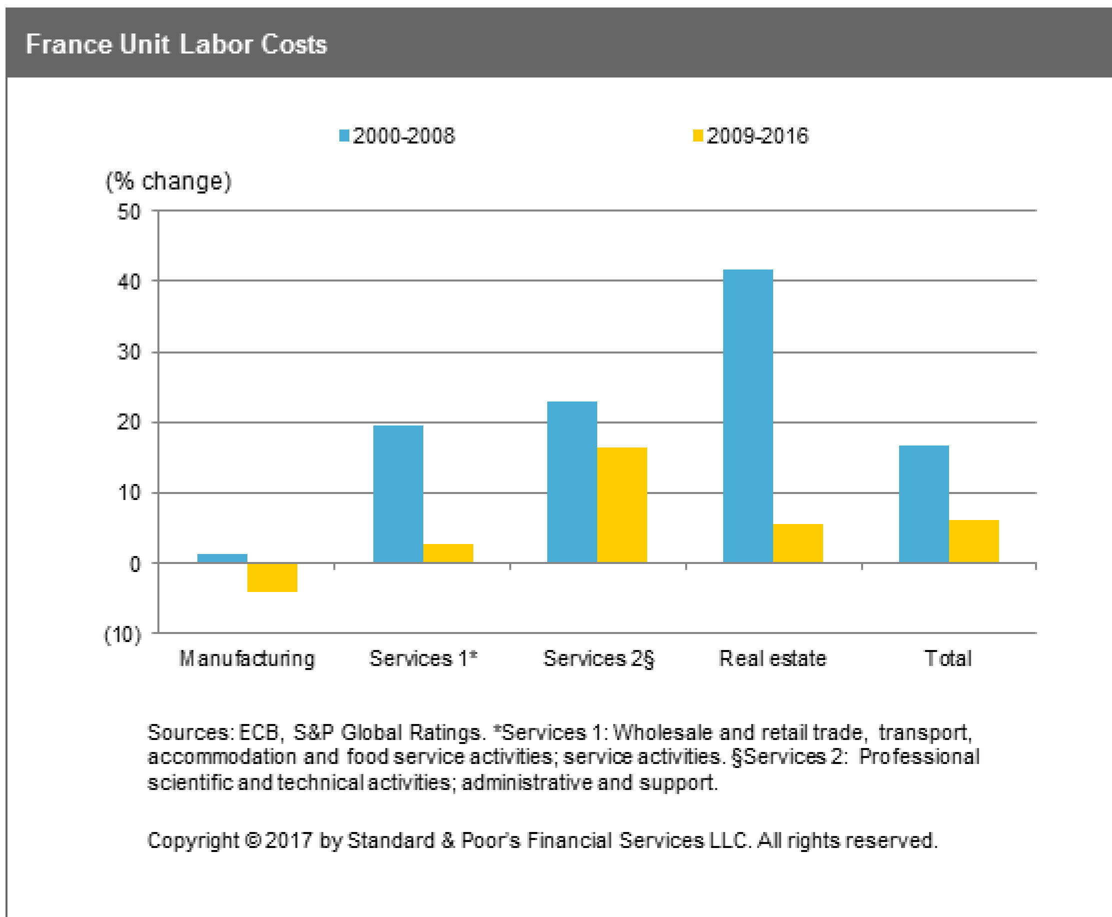
Chart 4



Low profit margins mainly concern the industrial sector; in contrast, margins remain relatively high and stable overall in the service sector. However, while nontradable sectors such as wholesale and retail trade, administrative and support services, real estate activities, and professional services enjoyed higher profits, they also featured comparatively lower productivity. Unit labor costs in these sectors have been much more dynamic relative to manufacturing (see chart 5). This partly reflects the high minimum wage in labor-intensive sectors that depend on low-skilled labor. By contrast, German unit labor costs in a selected number of these sectors remained stable, particularly between 2000 and 2008. But in those particular sectors, firms have been able to keep high margins by passing on the difference between wages and productivity growth to their end customer, owing to a lack of competition, particularly in certain regulated professions.

The higher prices in the services sector have increased the prices that French industrial firms pay for their intermediate consumption of goods and services. Compared with Germany's export sector, France's suffers from high input prices on real estate and professional services, for example. The margins differential prompted a shift in resource allocation toward services, accelerating deindustrialization and the structural deterioration in the merchandise trade balance.

Chart 5



A Rise In Investment R&D Could Break A Vicious Cycle

Manufacturing profit margins in particular need to rise first to increase investment capacity, allowing companies to innovate and improve the quality of their products. French exporters have increasingly been competing on price, therefore squeezing their margins, creating a vicious circle where lower profits hamper investments and in turn innovation. Indeed, France still has a relatively weak share of automation in industry reflecting the lack of innovation-oriented investment: According to the International Federation of Robotics, the operational stock of multipurpose industrial robots per 100 employees in 2015 amounted to 2.45 in Germany, 1.56 in Italy, 1.40 in Spain, but only 1.22 in France.

The lack of research and development and innovation spending led to the difficulties that French small and midsize enterprises (SMEs) have in growing and achieving critical size for export. France has fewer SME exporters at 38,152 than Germany or even Italy at 77,687 and 63,417, respectively (2014 data). These structural weaknesses require longer-term solutions that swings in currency and commodities prices cannot solve.

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