MACRON-OMICS
THE SEQUEL

September 2018

Image courtesy of skeeze, pixabay.com

CONTENTS

A company of Allianz

EULER HERMES

EXECUTIVE SUMMARY

Stephane Colliac, Senior Economist for France and Africa
+33 0 8411 3677
Stephane.COLLIAC@eulerhermes.com

- After a successful first year of long-awaited reforms, French corporates remain indebted and households lack purchasing power. The Government just published their 2019 budget proposal and economic policy objectives are clear: (i) a further reduction of government spending to deliver tax cuts; and (ii) the strengthening of incentives and financing for the private sector. Significant cyclical tailwinds will help keep the reform momentum.

- President Macron's economic policy can be summarized by five building blocks: (i) Trim public spending; (ii) Make social protection more efficient; (iii) Lower the fiscal burden; (iv) Improve the business climate; and (v) Incentivize households to save less and channel more savings to corporate financing. The growth impact of the whole reform agenda is positive (+0.2pp in real GDP growth per year), thanks to increased competitiveness and in spite of lower public spending.

Photo by Dorian Hurst on Unsplash

Real GDP growth positive impact of Macron's reform agenda, per year

+0.2pp

MACRON-OMICS

THE SEQUEL

France's economic pulse one year on

One year on after President Macron's first reform package, the country's scorecard still shows some weaknesses:
(i) a supersized government (fiscal spending reached 55.1% of GDP in 2017);
(ii) an indebted corporate sector (72.7% of GDP in 2018Q1);
(iii) high household savings (about 14% of disposable income per year) and sluggish consumption; and
(iv) a sizeable trade deficit (EUR63bn in 2017). For a private sector-friendly government, more can be done for corporates and households still faced with significant headwinds.

French corporates: High debt, low margins, and more defaults

2017 was a good year for the corporate sector; manufacturing production grew by +2.9%, hitting its best level in October of that year since October 2008. Moreover, a rising capacity utilization rate (85% in July 2018) meant that corporates had to keep on investing (+3.7% in 2018).

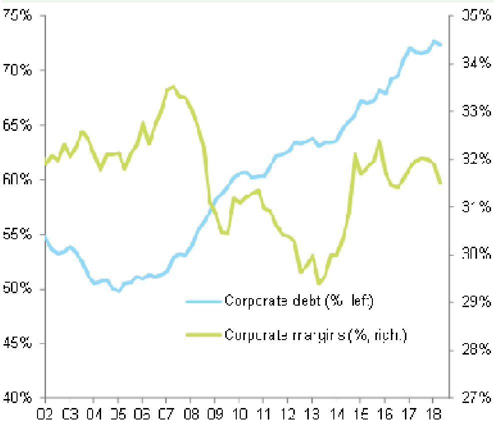
While corporate debt stabilized at 64% of GDP in the Eurozone, in France, debt increased from 60% of GDP in 2010 to 72.7% in Q1 2018 (Figure 1). This helped cope with lower margins than anywhere else in the Eurozone: 29.5% at its lowest level in 2013 and 31.5% in 2018Q2 (pre-crisis average level was 32.5%) in France (the current level is 40.8% in the Eurozone).

French households: Lacking purchasing power

Private consumption grew by +1.1% compared to +2.3% for overall GDP in 2017. The high household savings rate (14.3% in 2018Q2) coupled with unemployment fears have been capping consumer spending. In 2018, purchasing power eroded (-0.5% in Q1) as a result of a higher energy prices (+25% y/y in Q1). This contributed to households' perception that their financial situation deteriorated. Overall, their income growth did not translate into purchasing power growth (Figure 2).

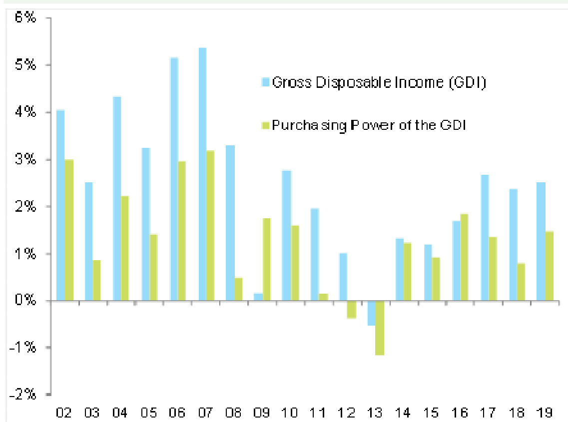
We expect consumption to grow by +0.8% in 2018, which is significantly lower than GDP growth for the second year in a row, because of limited purchasing power growth.

Figure 1 : Corporate debt in % of GDP and Corporate margins



Sources: IHS Global Insight, Banque de France, Allianz, Euler Hermes

Figure 2 : Gross Disposable Income and Household Purchasing Power Year/year changes



Sources: IHS Global Insight, Allianz & Euler Hermes Forecasts

What's next?

Macron-omics (Table 1) aims at "protecting, promoting and uniting" as stated by President Macron. After the first phase of reforms, France has five priorities going forward:
(i) Trim public spending;
(ii) Make social protection more efficient;
(iii) Lower the fiscal burden;
(iv) Improve the business climate; and
(v) Incentivize households' consumption and reorient their savings towards equity financing. This means that the government has to decrease in size and become more efficient; this is the only way for lower taxes. It also means that specific measures should be adopted in order to make French corporates more profitable.

Table 1 : Macron-omics building blocks

Block	Measure	Impact
Trim public spending	**Explicit final goal: lower spending to GDP ratio by -5pp to 2022**	
	1. Fiscal deficit reduction a. Tax rises (e.g. Generalized Social Contribution [CSG] increase) b. Tax credit cuts (end of the CICE, EUR 24bn, about 1% of GDP) c. Spending cuts (EUR 15bn in 2018)	-0.1pp on growth in 2018. This should be reversed by a net positive impact of +0.1pp thereafter
	2. SOE reform (SNCF): Prepare SOE to more competition and tackle spending rigidities	+1pp on government debt
Make social protection more efficient	**Implicit final goal: Convergence from the current cost (31.2% of GDP) to Eurozone average in order to allow for more tax cuts**	
	1. Labor market reform: more flexibility for employers, incentivize job mobility and reform vocational training 2. Pension reform: Unify 37 existing schemes by mid-2019. Reform of the way pensions are calculated is likely. 3. Health spending cuts: Neutralize the impact of trend spending increase through savings (in 2018, it implied a EUR 4bn target)	-0.1pp permanent negative impact on growth, driven by lower consumption (lower import propensity impact is captured in net exports estimate shown below)
Lower the fiscal burden for corporates	**Implicit final goal: Convergence of current taxation levels to OECD levels (target date not set)**	
	1. Corporate tax reduction (symmetrically to other advanced economies) to 25% in 2022	Corporate margins back from 31.5% in 2018Q2 to 33.5% by 2022 (first impact expected in 2019)
	2. Social contribution decrease: Employee contribution to be cut in 2018 (Health and unemployment to disappear, matched by CSG increase). Employer contribution to decrease by -6pp (replacing CICE). New announcements expected thereafter (depending on social protection reform)	Positive impact on Unit Labor Costs. Fully close the gap with Germany by 2022 and return to pre-2002 era. +0.3pp structural impact expected on net exports
Improve the business climate	**Implicit final goal: Revamp existing corporate financing schemes and improve most lagging business climate aspects**	
	1. Loi Pacte: a long list of measures designed to give more flexibilty for corporates and propose a new export strategy 2. Tacke high insolvencies level through new bankruptcy rules. Limit the duration of insolvency procedures. 3. Ease access to credit (lower the need for long DSOs). Fix information gaps: enlarge balance sheet data information to SMEs	Make growth less debt intensive (72.7% of GDP in 2018Q1) and less DSOs intensive (Days of Sales Outstanding were 74 days in 2017). Lower insolvency numbers. Have 220000 exporters by 2022
Incentivize households' consumption and reorient their savings towards corporates	**Implicit final goal: Lower saving needs and channel a wider share of it to equity financing**	
	1. Lower construction costs through the ELAN plan, basically by reducing barriers to construction 2. Reduce the cost of housing through lower taxation (Housing tax elimination) and reduce tax incentivizing household housing demand (narrowing the scope of Pinel Law and zero rates on loans for first time buyers) 3. Reduce capital gains taxation through a flax tax (30% of the income)	Lower household saving ratio by 2pp to 12% of their disposable income by 2022, through a reduction of share needed in order to invest. Change the share of equity financing in household financial savings from 30% currently to a higher share.

Sources: Allianz & Euler Hermes

Trim spending

France has one of the highest levels of public spending in the world (Table 2). It was about 55.1% of GDP in 2017 (compared to about 44% of GDP in Germany), and the highest tax to GDP ratio in the European Union (47.6% of GDP in 2016 according to Eurostat, 45.4% of GDP in 2017 according to INSEE).

Since fiscal deficit reduction is paramount, tax cuts will be implemented later, likely after a decrease in fiscal spending and after correcting some tax loopholes. This would have a negative impact on growth in 2018,
estimated at -0.1pp. The first kind of spending cut will come with the unwinding of previous tax credits, like the CICE (Tax Credit for Competitiveness and Employment purpose). It will be implemented in 2019 (EUR24bn, or 1% of GDP), with an impact being visible on 2020 fiscal accounts. The second kind will be harder cuts, such as fewer subsidized job contracts (in line with decreasing unemployment), and a reduced public sector wage bill.

Make social protection more efficient

According to Eurostat, social security funds represented 52.8% of total taxes in France in 2015, compared to 30.2% in the European Union. Moreover, public social spending amounted for 31.2% of GDP in 2016, by far the highest level in the OECD (21% on average).

The government will reform each part of the current welfare system:

- Labor market/unemployment benefits: the final goal is to break the insider/outsider structure of the labor market in order to allow for more free entry (particularly reduce youth unemployment). A labor law was implemented in 2017 to give more flexibility to employee/employer negotiations. Along with improvements to the labor market, the government will progressively unwind subsidized job contracts. The universalization of unemployment benefits will be self-financed through lower unemployment and controls on job search according to the government.

- Pension reform: the overarching goal of the reform is to unify the current 37 systems in order to reduce inequalities of pension conditions (age of retirement, mismatch between financing and pensions for specific regimes). The current system is one of the most expensive in the OECD (14% of the GDP in France vs. 8.2% on average in the OECD). Pension reform will also imply a change in the way pensions are calculated. The traditional defined benefits system (fixed pension levels are based on the contributions made and are not state-contingent) should be replaced by a defined contribution system (benefits are state-contingent, evolving with many aspects such as evolving life expectancy).

- Health: the government goal is to neutralize increased spending driven by increasing population needs while keeping the budget constant through a wider use of generics and other solutions to lower the cost of the system.

... To finally be able to lower the fiscal burden on corporates

The corporate tax burden in France is one of the highest in the world (Figure 3), about 62% of their total profits. Social contributions make the bulk of their contribution (two third), along with two other items: taxes on production and the corporate tax (about one sixth each). After necessary spending cuts, two main tax breaks should follow:

- In 2019, lower corporate tax rates from 33%, 2018 to 28% for SMEs (with profits under EUR500k), and 31% for the others. By 2022, the tax rate should be 25%, in line with other countries.

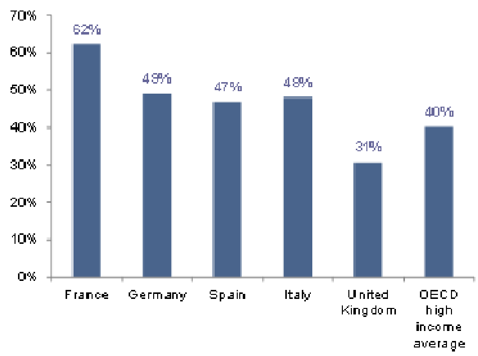
- A decrease of employers' social contribution. The end of the CICE in 2019 will be backed by a -6pp social contribution decrease (EUR 24bn).

Table 2: Public finance scenario

	2015	2016	2017	2018	2019	2020
GDP growth (constant prices)	1.0%	1.1%	2.3%	1.5%	1.9%	2.0%
GDP growth (current prices)	2.7%	1.3%	3.0%	2.3%	3.0%	3.3%
Gov revenue (% of GDP)	52.2%	51.8%	52.4%	52.1%	51.1%	50.5%
Gov. expenditure (% of GDP)	55.8%	55.2%	55.1%	54.7%	53.9%	52.7%
Fiscal deficit (% of GDP)	-3.6%	-3.4%	-2.7%	-2.6%	-2.8%	-2.2%
Primary deficit (% of GDP)	-1.4%	-1.3%	-0.6%	-0.7%	-1.0%	-0.4%
Debt to GDP ratio	97.5%	98.4%	98.5%	98.9%	99.2%	98.5%

Sources: IHS Global Insight, Allianz, Euler Hermes Forecasts

Figure 3: Total corporate tax and contribution (% of profit)



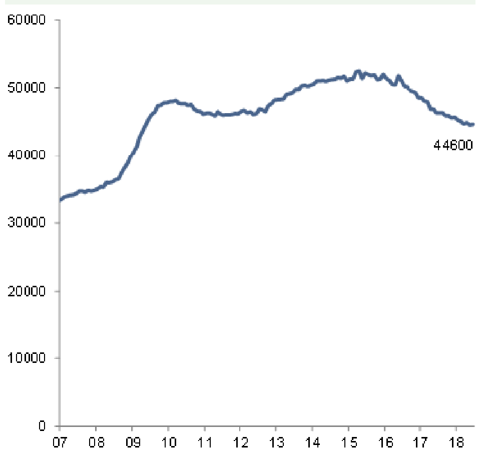
Sources: Worldbank,, Allianz, Euler Hermes,

Improve the business climate, especially for SMEs

French corporates suffer from higher DSOs (74 days in 2017, +2 days compared to 2016), compared to 62 days on average in Western Europe. SMEs prefer to use suppliers' credit instead of bank credit, despite a new law aimed at capping DSOs to 60 days. As a result, corporate insolvencies are still 33% higher compared to early 2007 (Figure 4) and resolving insolvencies takes almost two years in France. In addition SMEs need more cash in order to cope with working capital requirements, are more risk averse, especially abroad.

The "Loi PACTE" is a first attempt at improving the business climate for SMEs. It includes the option to include a cross-class cram down clause in insolvency resolution (a kind of collective action clause), and changes threshold for tax regime (from 20 to 50 employees e.g.) among other efforts to change the daily life of corporates.

Figure 4 : Corporate insolvencies in France (12-months run)



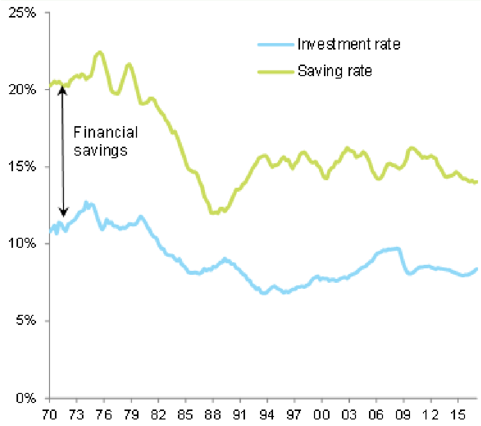
Source: Euler Hermes,

Incentives households' consumption and reorient their savings

Many comments have been made on household purchasing power and consumption behavior. The missing consumer was at the earth of the disappointing growth performance in H1. Some tax cuts will help, in this regard, such as the cut of health and unemployment contributions (backed by an equivalent hike of the CSG levied on wage, but also pensions).

However, higher consumption can also be triggered by lower savings. Government forecasts show that household savings should reach 14.7% of their disposable income in 2018 (the highest level since 2012). Household savings and investment rates have been stable during the last years (Figure 5), and so did the resulting financial saving surplus (4.8% of GDP in 2017).

Figure 5: Household savings and invest ment (% of Gross Disposable income)



Sources: IHS Global Insight, Allianz, Euler Hermes

This is somewhat of an anomaly since this surplus generated low yields at the very end of the period, but it is well-explained by supplementary savings related to ageing or unemployment fears.

The reform of the welfare state is one way to address these worries and lower the perceived saving needs. Back in the 80s, there was a long period where savings decreased substantially. Financial savings lowered from 10% to 3.5% as a result of lower yields, and savings for investment purposes also dramatically decreased.

Photo by Joshua Earle on Unsplash

The government announced several measures able to tackle the excess household savings, among them a revamp of the housing sector policy ("Loi ELAN"), which includes tackling barriers to construction (lower the cost and the number of procedures needed). It would help to lower investment costs. The government also decided to progressively eliminate the housing tax (taxe d'habitation), replacing the wealth tax by a tax on housing wealth tax only, and implementing a flat tax on capital income.

According to the European Commission, the implicit tax rate on capital income was 52.7% in France in 2015 (24% in Germany or 34% in Italy), and increased by +10pp since 2000. The flat tax (30% of income) will free up resources and allow less distortion in the allocation of household savings (less than 30% of financial savings were invested in equities in 2017). This genuine reform is welcome since efforts to develop equity financing by households were largely put on hold after the golden era of the 80s.

So, what is the net impact of Macron-omics?

Overall, we estimate the growth impact of the whole reform agenda to be net positive (+0.2pp growth per year). Positive impacts would particularly be driven by a structural improvement of net exports (competitiveness impact of lower social contributions and lower imports) by +0.3pp, dampened by lower (government) consumption by -0.1pp.

Stéphane Colliac

Director of Publications: Ludovic Subran, Chief Economist
Euler Hermes Allianz Economic Research
1, place des Saisons | 92048 Paris-La-Défense Cedex | France
Phone +33 1 84 11 35 64 |
A company of Allianz

http://www.eulerhermes.com/economic-research
research@eulerhermes.com
euler-hermes
eulerhermes

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

NO DUTY TO UPDATE