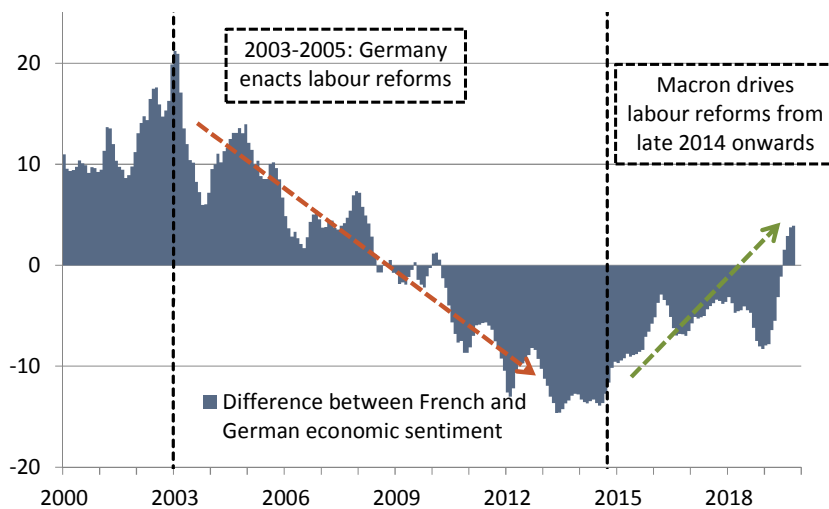


30 October 2019

France versus Germany: changing of the guard

Switching places: new leader for European long-term growth?



Index of economic sentiment of France relative to that of Germany. Three-month average of difference. For both indices 100=long-term average. Source: European Commission, Berenberg

- **Vive la France!** Trade tensions and Brexit woes have taken a heavy toll on Europe for the past two years. While growth has more than halved since the end of 2017, France is weathering the challenging external environment better than most European peers, especially Germany. The observation that France is doing better than Germany is not based just on a snapshot in time, though. Instead, it signals a long-term trend driven by each country's (lack of) reform drive.
- **French economy less exposed to swings in global trade:** Due to the structure of its economy – a relatively low export ratio of just 31% versus 47% for Germany, a focus on the export of less cyclical products such as food and pharmaceuticals versus Germany's cars, chemicals and machine tools, and a 70% share of services in GDP compared with Germany's 62% – France is better shielded from the global cycle than its neighbour. Whereas the huge size of the public sector is a source of concern for France's long-term growth, it dampens the short-term fluctuations of demand.
- **Benefitting from good policy choices at home:** Emmanuel Macron's pro-growth policy measures – first as economy minister from 2014 to 2016 and since 2017 as president – contribute significantly to the current French strength, and should do so increasingly over the long term. Earlier this year, Macron loosened the fiscal reins just when the global slowdown turned more serious. His labour market reforms and corporate tax cuts have boosted business investment. Private sector employment growth has been healthy at c1.3% yoy. The share of permanent jobs has risen from 48.7% in late 2016 to 49.7% in Q2 2019 as the government has made open-ended contracts cheaper for employers. The scrapping of a wealth tax on all assets other than property, a flat tax on capital gains and a special visa has attracted start-ups: the number of monthly business registrations in France – 63k on average between May and July (latest available data for both countries) – surpassed that of Germany (56k) for the first time in at least 20 years.
- **All that glitters is not gold:** Structural unemployment is still high. Even with 2.5m unemployed, almost 200k job vacancies remain unfilled for lack of skilled and willing labour. With reforms to the unemployment insurance as well as the training and education system, Macron is addressing the mismatch. To place France's debt-to-GDP ratio of just under 100% on a firm downward path, Macron also needs to make more deliberate, targeted cuts to government expenditures to finance his tax policies. To secure the long-term funding of the pension system, he will not only have to merge the 40 or so different schemes, but also accelerate the planned increase in the effective retirement age.
- **A golden decade for France?** Since Macron came to power, we have maintained that his pro-growth reforms could usher in a golden decade for France in the 2020s, with the country taking the place of a complacent Germany as the top performer of the major economies in Europe. Our chart shows that the shift of economic sentiment in France relative to Germany since Macron took charge of reforming the French labour market reform is similar to what happened in Germany since Chancellor Gerhard Schröder introduced labour market reforms in 2003-2005. Importantly, Macron does not seem to have lost his reformist zeal. With more than 2.5 years until the next election, he still has time on his side. So far, we see no reason to change our positive outlook for France.

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