

Prospects

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FRANCE – Economic Environment

Things are looking up for the manufacturing sector

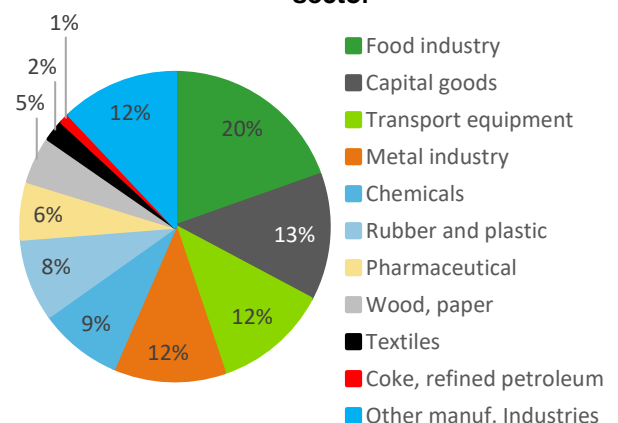
- In the current environment of trade and geopolitical uncertainty, the French industrial sector is holding up better than that of other countries more integrated in global value chains.
- Manufacturing output seems to have bottomed out but is not likely to rebound sharply. In the short term, activity will probably stabilise before beginning a gradual recovery.
- Although the manufacturing sector's contribution to the economy is shrinking, it remains a driver of productivity gains.
- Four sectors with a positive trade balance are supporting French exports' competitiveness.
- Despite the concerns raised by the announcement, the rise in US tariffs has so far had a negligible impact on French exports.
- Reforms undertaken since 2013 have led to a slower increase in labour costs in France than in Germany, boosting cost competitiveness in the French manufacturing sector and enabling an upturn in investment and net job creations in recent years.
- At a structural level, reforms, which have cut business taxes and raised competitiveness, and the economy's specialisation in dynamic sectors (aerospace, pharmaceuticals, chemicals) should strengthen the French manufacturing sector in the long run.

Manufacturing activity slowdown could come to an end

The slowdown in manufacturing around the world is affecting France, but to a lesser extent.

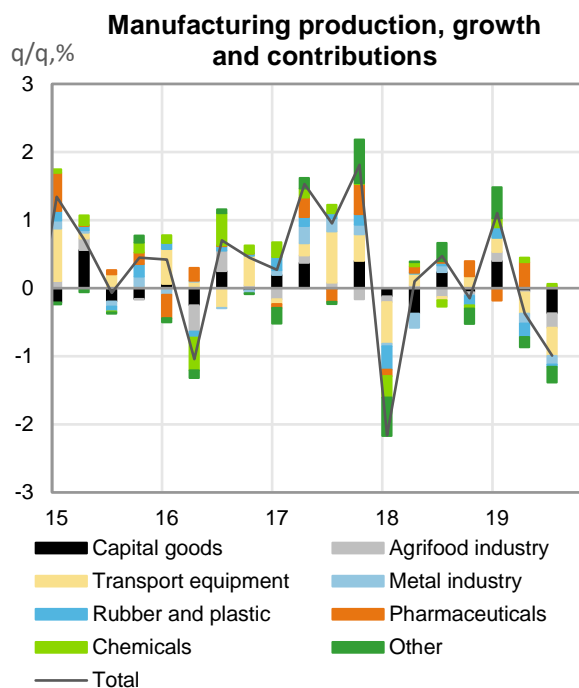
In recent years, the French industrial sector has expanded in high value added cutting-edge sectors such as aeronautics, pharmaceuticals and chemicals, while other sectors such as metals and textiles have become less important. The agrifood industry has held up fairly well and still accounts for 20% of the value added produced by the manufacturing sector. It is one of the four business sectors in which France has a trade surplus.

Manufacturing: value added by sector



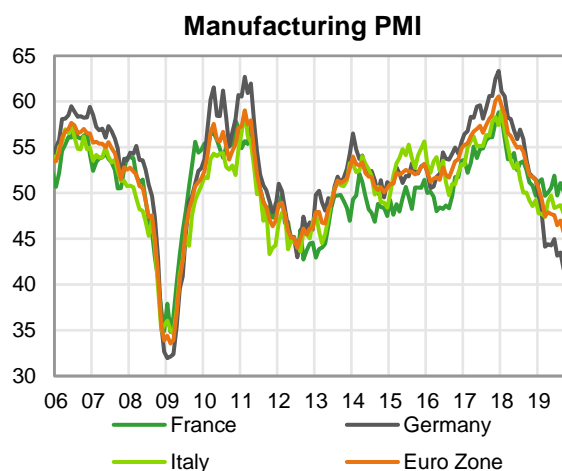
Sources: INSEE, Crédit Agricole SA.

Growth in manufacturing output by volume (and value added) slowed sharply in 2018 to 0.3% (0.1% for value added), after a strong performance of +2.8% in 2017. In addition, output growth (and growth in value added) was negative in Q2 and Q3 2019. The carryover effect on growth for 2019 currently stands at +0.5%.



Sources: INSEE, Crédit Agricole SA.

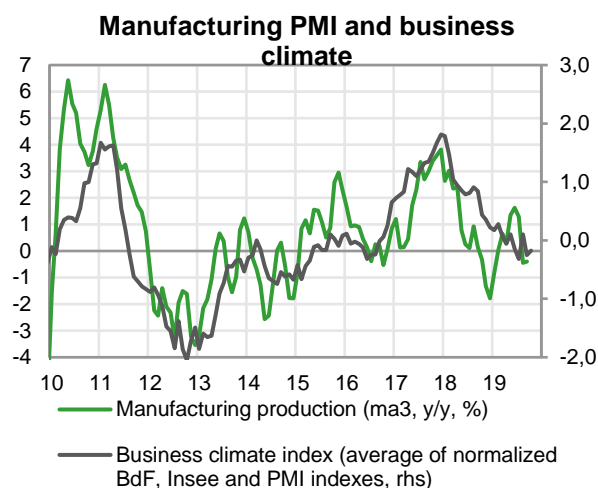
These figures should be considered in light of the global slowdown in manufacturing activity caused by both trade tensions and geopolitical uncertainty more generally. Regulatory changes in the automotive sector with the implementation of the WLTP environmental standard in September 2018 have also had a major impact on manufacturing, especially in Germany. The inventory cycle has also exacerbated the contraction in manufacturing activity. Against this backdrop, manufacturing activity seems to be holding up better in France than in its neighbouring countries. In addition, weakness in manufacturing output has a lesser overall impact in France, where it accounts for 10% of GDP, than in Germany, for example, where its share in value added amounts to 21% of GDP. The fact that France is less integrated in global value chains also limits the knock-on effects of the slowdown in global demand on the French industrial sector. Manufacturing surveys have remained stronger in France than in other European countries, and output has slowed less.



Sources: IHS Markit, Crédit Agricole SA.

Manufacturing activity looks set to stabilise. Ahead of a slow recovery?

The slowdown in manufacturing activity that began in 2018 could have bottomed out in the third quarter of 2019. While a sharp recovery is still not on the cards, manufacturing activity could stabilise for the time being. First, manufacturing business surveys have shown signs of stabilisation since around April. While business surveys can show sharp declines from one month to the next, the average of the three main surveys (INSEE, PMI by IHS Markit and Banque de France) has been fairly steady over the past six months, pointing to a slight increase in industrial activity over one year. For now, the carryover effect in Q4 is showing a stabilisation in manufacturing activity compared to the previous quarter, following contractions in Q2 and Q3.

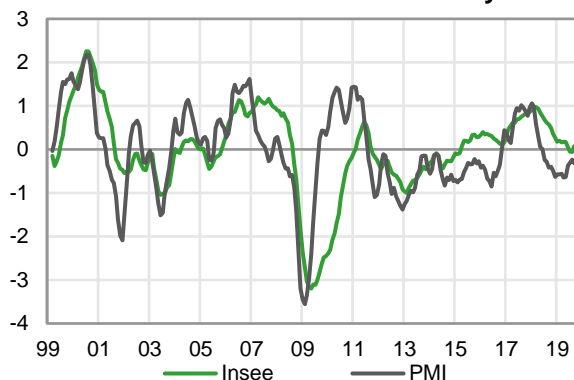


Sources: Banque de France, INSEE, IHS Markit, CASA Eco.

Moreover, business survey indicators of overall orders have picked up slightly from the lows recorded at the start of 2019. In particular, export orders (spread over 3 months) have risen slightly in the PMI survey and have remained very near their historical average (here, the indicators have been standardised, with an average of 0). They do not

indicate a sharp rebound in activity in the months ahead, but they too point to stabilisation, which could pave the way for a gradual recovery in coming quarters.

Normalized indexes of manufacturing export orders from INSEE and PMI business surveys

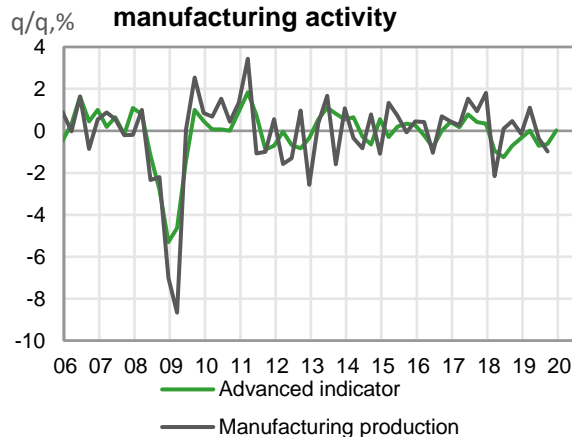


Source: INSEE, IHS Markit, Crédit Agricole SA.

Based on these observations we expect manufacturing activity to stabilise in the quarters to come. Manufacturing output is expected to show fairly weak growth in 2019 (0.4%) and it could contract slightly in 2020, in particular due to the negative carryover effect. Before considering a possible recovery in the second half of 2020, leading indicators currently seem to suggest that manufacturing output will be flat at the start of the year.

Our leading indicator of manufacturing output confirms these observations. Based on the different components of business surveys and in particular advanced components such as export orders and the inventory cycle, our leading indicator suggests manufacturing activity will be more or less flat in Q4 after -1% in Q3. Over the full year 2019, manufacturing output is therefore expected to rise by 0.4%, after 0.3% in 2018.

Advanced indicator of manufacturing activity



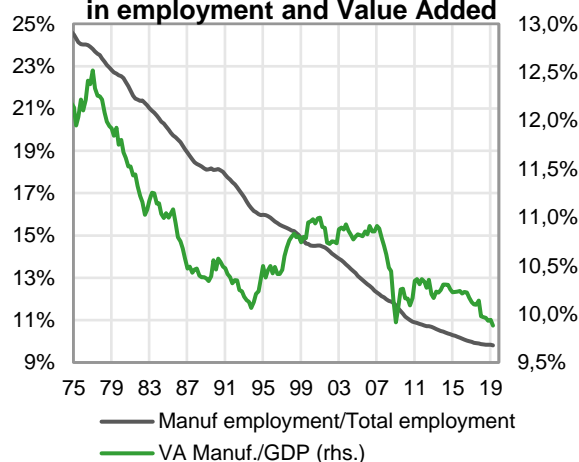
Source: Crédit Agricole SA.

Structural improvements in competitiveness in the manufacturing sector

Although the manufacturing sector is less important than before, it remains a driver of productivity gains.

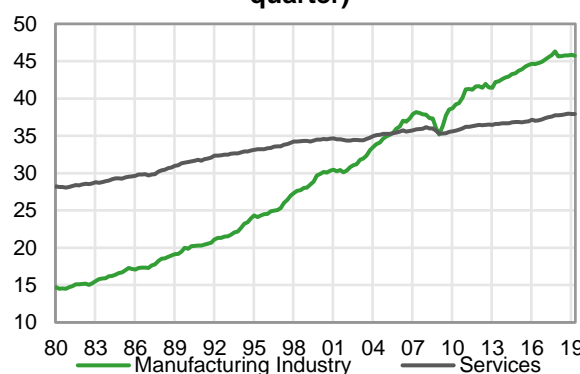
The manufacturing sector's contribution to French GDP has declined considerably over the past 40 years. This decline hit the labour market particularly hard as the manufacturing sector still accounted for 23% of total employment in 1980 against around 10% today. In terms of value added, the manufacturing sector now accounts for only 10% of GDP, versus 12% 40 years ago.

Weight of the manufacturing sector in employment and Value Added



Sources: INSEE, Crédit Agricole SA.

Labor productivity (VA in volume by FTE in thousands of EUR by quarter)



Sources: INSEE, Crédit Agricole SA.

However, manufacturing still is a strategic sector for the French economy, in particular because it remains one of the main drivers of productivity gains. The fact that manufacturing employment has declined faster than value added illustrates these employment productivity gains over the long term. From 1980 to 2019, manufacturing productivity rose by an average of 3.7% per year, compared with just

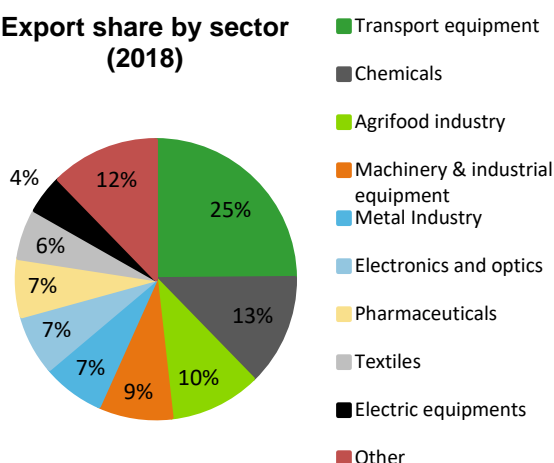
1.5% in the services sector. Productivity gains have, however, slowed sharply since 2018 due to the global economic environment. While job creations have been strong in recent quarters, activity growth has slowed sharply. Year on year manufacturing productivity growth was slightly negative in the second quarter of 2019.

These productivity gains have been particularly strong in certain business sectors, which has led to a specialisation of the French industry and to faster growth in high value added sectors, which are underpinning exports.

The competitiveness of French exports relies on a few fast growing sectors.

Major deliveries are due in the aerospace and shipbuilding sectors in the fourth quarter of 2019, and this should give a temporary boost to France's trade balance. The transport equipment sector (which also includes the automotive sector) is indeed the main driver of French exports. While it generates just 12% of value added in the manufacturing sector, it accounts for one quarter of goods exports.

Export share by sector (2018)

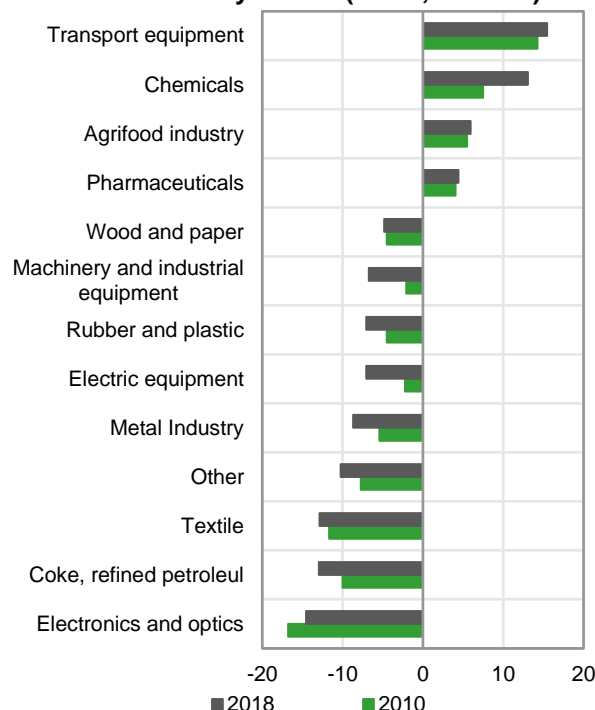


Sources: Direction générale des douanes, Crédit Agricole SA.

Transport equipment is one of the four sectors to boast a trade surplus, and this surplus has increased in recent years. Although the automotive segment is included in the transport equipment sector, the automotive trade balance has been negative in France since 2008. This is due to imports of foreign cars, especially from Germany, and to growing imports by French manufacturers of cars produced abroad (in Spain and Eastern Europe mostly).

The transport equipment trade surplus is therefore solely due to aerospace and shipbuilding activities. In 2018, the sector helped stabilise France's trade deficit by generating a surplus of €15.5 billion thanks to major deliveries by Airbus and the delivery of two cruise ships to the United States.

Net trade by sector (value, EUR bn)



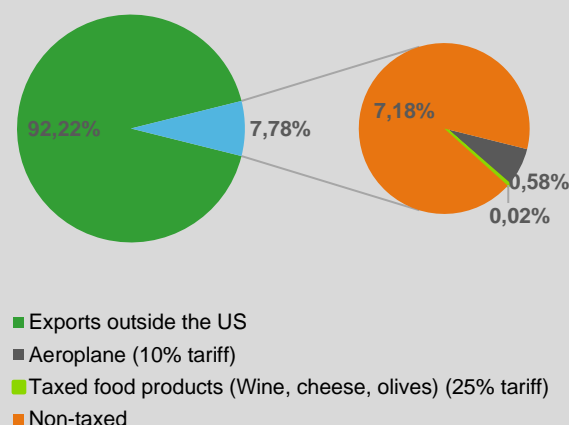
Sources: Direction générale des douanes, Crédit Agricole SA.

US customs duties: the impact has so far been negligible

The transport equipment sector (in particular when excluding autos) is the star performer of the French manufacturing sector and is one of the sectors in which France has a real comparative advantage.

The US administration recently turned its attention to this sector, applying customs duties on aircraft imports from the European Union and on other products such as French wine. While the announcement stoked fears about the major consequences this would have on the French economy, the impact on exports is very limited. Only €3 billion in French exports are concerned, representing 7.7% of exports to the United States and only 0.6% of France's total exports in 2018.

French exports to the US (% of french total exports in 2018)

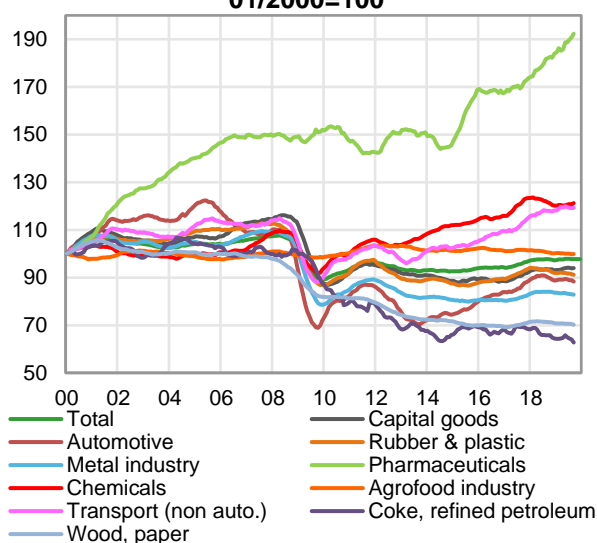


Sources: Direction Générale des Douanes, INSEE, Crédit Agricole SA.

According to a recent study by the French Treasury department, France has a comparative advantage in high tech sectors such as chemicals, aerospace and pharmaceuticals, which are also sectors with a trade surplus. The same study shows that these three sectors are those in which output has grown the most over the past 20 years and those in which the comparative advantage has increased. In contrast, other less competitive industries like the automotive and metals sectors are contracting.

This comparative advantage and the economy's specialisation are good news for French industry, which is often deemed to be uncompetitive.

Manufacturing production by sector
01/2000=100



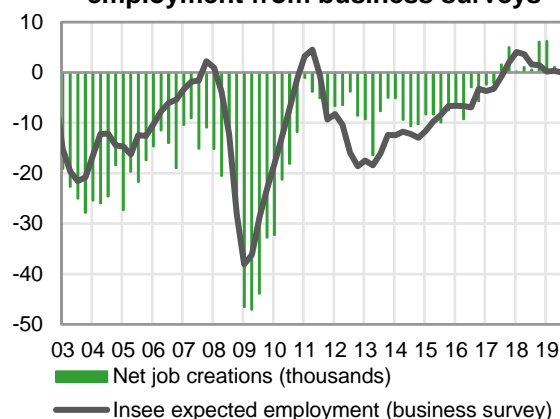
Sources: INSEE, Crédit Agricole SA.

A turnaround in the labour market, in part thanks to recent reforms

The manufacturing sector created jobs in 2017 and 2018 and should also do so in 2019 although the pace of job creation is expected to slow at the end of the year due to the contraction in activity in the sector overall. However, employment indicators in business surveys remain well above their historical averages and point to an overall stabilisation of employment in the sector in the near term rather than a renewed downturn.

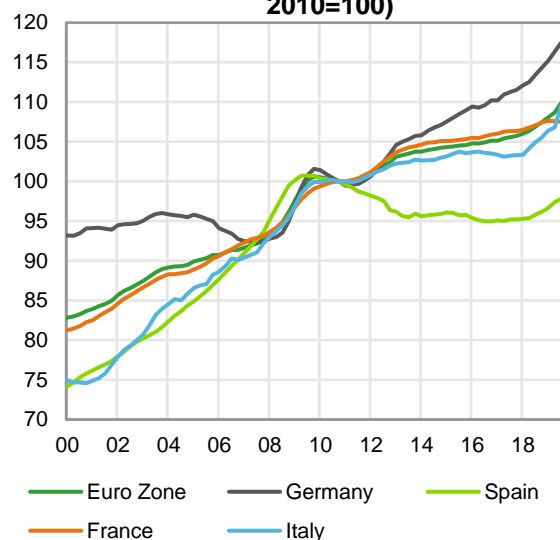
This stabilisation in employment after two years of net job creation confirms the end of the downward trend in manufacturing employment seen in recent decades. As well as being spurred by the acceleration in growth in 2017, jobs creations can be partly attributed to reforms led since 2013 (when the CICE tax credit for employers was introduced) to lower labour costs, in particular on low wages.

Net job creations and expected employment from business surveys



Sources: INSEE, Crédit Agricole SA.

Unit labor cost in the Euro Zone (Q1 2010=100)



Sources: Eurostat, Crédit Agricole SA.

Cost competitiveness in the manufacturing sector has improved in recent years, as shown by trends in unit labour costs (labour costs per unit of value added in volume) in France in relation to its neighbours, especially Germany. The hourly cost of labour in the manufacturing sector is now lower in France than in Germany. This was not yet the case in 2012. Cost competitiveness should continue to improve in France. In 2019, the CICE tax credit was replaced by a permanent reduction in employer contributions and will be supplemented by a further cut to payroll taxes on low wages. This additional tax break on low wages could explain the strength of job creation in relatively low-tech industries such as the agrofood sector.

Recent reforms have lowered companies' labour costs and taxes. This has enabled them to take on new staff, increase their margins and invest more, further specialising the manufacturing sector and increasing its non-price competitiveness.

In summary, the French manufacturing sector could be nearing the end of the tunnel. First, in cyclical terms, we can see a stabilisation in activity after several quarters of decline. More structurally, manufacturing employment trends have reversed since 2013. Recent reforms have improved the cost competitiveness of French industry and enabled businesses to hire and invest in a sector that generated net job losses in recent decades. Tax pressure on businesses should continue to ease in the years ahead with the planned reform of corporate income tax and the forthcoming Pacte Productif 2025 programme. In addition, the sector is specialising in dynamic activities such as aerospace, chemicals, pharmaceuticals and luxury goods, while the structure of German industry seems less competitive. These sectors are already powering French exports and their contribution is expected to increase in the years to come. ■

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