France

Supply and demand

- **France is suffering from both supply-side and demand-side problems. This is the analysis made by most of the international institutions.**
- **This is not as contradictory as it might sound: an economy can experience structural problems that limit its potential growth while at a given time still be hit by a shortage of demand.**
- **The big question is how to reconcile supply-side improvements and demand stimulus. One response highlights the positive impact of structural reforms on demand in the short term through wealth effect. A second response underscores the key role of investment, which is both a component of demand and a source of productivity gains.**

Today, most of the international institutions (foremost of which are the IMF, OECD, and European Commission) point out the structural imbalances of the French economy arising from its low potential growth, which is dependent on supply-side factors. The same institutions also agree that France has a negative output gap, i.e. that the actual level of production is below potential, a sign of a demand shortage. This raises the question of whether France's problem is one of supply or demand. In this article, we are not trying to settle the matter one way or the other, but rather to clarify the stakes and, to a certain degree, to question its pertinence.

Supply-side problems

The French economy's supply-side difficulties are well-documented. They formed the basis for revising down potential growth estimates in recent years. According to the OECD, France's potential growth rate has slipped from an average of 1.8% in 2000 to 2009, to 1.1% since 2010. Potential growth corresponds to the cruising speed at which an economy *at equilibrium* (i.e. when aggregate demand equals aggregate supply) can grow without overheating. In the long term, it depends on demographic factors and productivity gains, i.e. changes in the size of the working age population and their output. France is not the only economy hit by a decline in potential growth: slowdown in technical progress is global and a lot of advanced economies are affected by ageing population. But specific developments, such as high structural unemployment or lack of productive investment, can aggravate these trends. This is the case in France. Inversely, improving these factors can be a way of raising potential growth. This is why the international institutions have issued various recommendations to implement structural reforms in order to stimulate supply and, more specifically, to improve competitiveness.

Shortage of demand

At the same time, the IMF, OECD and European Commission all estimate that France has a negative output gap, even though their estimates vary significantly. The OECD estimates the negative output gap at 2.3% (of potential GDP) at year-end 2016, compared to 1.8% for the IMF and 1.3% for the European Commission. According to this analysis, France's sluggish growth in recent years is not due to supply-side constraints hindering production, but rather to a shortfall of demand. This assessment seems corroborated by the low level of core inflation, which averaged 0.4% year-on-year over the past three months, suggesting that the economy has some underemployed resources. Stimulating demand – via fiscal measures, for example — would generate more vigorous growth, lifting it above the potential growth rate (it being understood that GDP growth above potential is necessary to close the output gap). The impact on public finances would depend on the fiscal multiplier, that is to say GDP variation in response to a 1%-increase in public spending. A multiplier equal to or higher than 1 would stimulate demand without raising the debt-to-GDP ratio.

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Should we conclude then that France is suffering from a shortage of both supply and demand? It is conceptually possible to imagine an economy experiencing structural problems that hinder potential growth while at the same time recording a level of production lower than it should be (i.e. lower than potential GDP). This brings us to the big question of how to reconcile supply-side improvements and support for demand. The stakes are high: numerous studies show that an extended period of a demand shortfall can have a significant, lasting impact on supply.

Faced with this challenge, several institutions highlight the positive impact of structural reforms on demand. This is notably the case for the ECB. By raising productivity expectations, and thus expectations of future revenues, supply-side policies act as a wealth effect that stimulates spending in the short term. But a certain number of conditions must also come together: economic agents must make rational expectations and not be squeezed by liquidity constraints; and the credibility of the reforms must be strong.

Another response underscores the key role investment plays, as both a source of demand and productivity gains. In this respect, the priority is often placed on investment in infrastructure and human capital. This kind of public investment is esteemed to have a high multiplier effect because of its stronger knock-on effect on private investment, notably when the output gap is negative. This explains the debate about introducing a "golden rule" that excludes certain public investments from European fiscal criteria.