

Cost and Quality: The French Economy's "Competitiveness" Problem

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The French economy's lack of "competitiveness" is often attributed to high labor costs. Recent research, however, suggests that the export performance of advanced countries has less to do with labor costs than with product quality and the ways businesses invest.

For over a decade, France's trade deficit has been a cause for concern. Whereas France's foreign trade¹ remained, in 2004, generally balanced, its trade deficit is now equal to 3% of the country's GDP. Several clues have been explored to account for this trend. It is a striking development, particularly when one compares France to Germany, a country that, since the early 2000s, has achieved increasingly large trade surpluses. Notable explanations include unfavorable sector specialization and geographic location, as well as weak price competitiveness.

Recent studies, however, make it necessary to minimize these factors. Germany's success on international markets is, in fact, the result of the non-price competitiveness of German products: despite their high cost, consumers are prepared to buy them because of their quality, image, or innovative character. Meanwhile, France is, in these domains, falling behind.

Non-price competitiveness has become an essential dimension of the export performances of companies as well as countries. It has become central to the work of economists who study international trade. This article examines these recent trends.

After clarifying the concepts of price competitiveness, cost competitiveness, and non-price competitiveness, we will discuss the stakes of defining and measuring the quality and non-price competitiveness of exported goods. Next, we will see how international competition leads developed countries to specialize in product varieties notable for being highly non-price competitive. Moving upmarket has several implications for these countries' economies (relating to corporate demographics, labor markets, and export volatility and growth). Finally, we will show that to conquer new markets, companies must go upmarket and, consequently, invest. In this way, cost competitiveness becomes a key aspect of companies' non-price competitiveness.

Price Competitiveness, Cost Competitiveness, and Non-Price Competitiveness

It is sometimes said that France has fallen behind Germany on international markets due to unfavorable sector specialization and geographic location. Reports by Artus and Fontagné (2006) and Fontagné and Gaulier (2009) of the Economic Analysis Council demonstrate, however, that the opposite is true.

¹ The difference between exports and imports.

A careful breakdown of the growth in exports shows that the performance gap between the two countries can only be very marginally attributed to differences in sector specialization (which, incidentally, have tended to converge over the past decade) and geographic location. Yet in specific markets, French exporters are clearly doing less well than their German counterparts.

Nor can these weaker performances be explained by pointing to the price-competitiveness differentials between the two countries. The primary indicators of price competitiveness—that is, indicators measuring the relative price of French exports compared to German exports—do not indicate that France has fallen behind in this respect. Yet since the early 2000s, France’s cost-competitiveness has declined: the production costs of French companies are increasing faster and exceeding German costs. Salary costs are not the main reason for this trend, as these are not higher in France than in Germany (even if it is true that, over the past ten years, industrial wage costs have grown faster in France than in Germany, despite being initially lower). The reason for this decline lies, rather, in the cost of intermediary consumption², which is declining in Germany compared to France: German companies have relied more than their French counterparts on strategies that externalize stages of the production process to low-wage countries, notably in Eastern Europe.

We thus find ourselves before a paradox of sorts: whereas, compared to France, German production costs have tended to decrease, German relative prices have not. German producers have used relative decreases in cost to raise their profit margins, whereas French producers have, to the contrary, absorbed some of their cost disadvantages by cutting their profit margins. Even so, Germany has managed to expand its market share in France, notably in high tech and high-end goods (Cheptea et al., 2014).

If German exporters continue to prosper while keeping their prices high, it is because they are becoming increasingly non-price competitive.

Definition and Measurement of Non-Price Competitiveness

There exists no commonly accepted definition of non-price competitiveness. The concept refers to anything that renders a product attractive to the consumer, however expensive it may be. Naturally, product quality is one factor in non-price competitiveness and economists who study international trade have, in recent years, frequently analyzed it. Access to more detailed data on trade flows by country (or by company) and by product (where it can be broken down very precisely by category) has stimulated research into these questions. Indeed, as this data is available both in value and in volume, it is possible to calculate the per-unit value of a country’s exports of a particular product, i.e., the price at which a particular country exports a ton of a particular good.

In this way, using American data, Schott (2004) shows that in 1994, men’s shirts imported from Japan were thirty times more expensive than those imported from the Philippines. On average, of all the products imported by the United States, the ratio between the most expensive and least expensive varieties is 24. However, *The Economist’s* Big Mac index, which measures the price

² The totality of goods and services that are used—i.e., destroyed and/or transformed—in the course of the production process.

differences of the well-known hamburger in various countries through 1999, puts this same ratio at three (i.e., for a Big Mac). As the hamburger is identical and is made the same way throughout the world, its price variations largely reflect international differences in production costs and standards of living. The price differentials of American imports are so great compared to those of the price of a Big Mac that they cannot be attributed solely to differences in production costs. A more advanced analysis of the data suggests, moreover, that countries with the highest levels of capital and skilled labor and the richest countries tend, for any given product, to export the most expensive varieties of it. Similarly, countries experiencing the fastest growth in capital and skilled labor (and the income they generate) are also the countries where the per-product price of exports is growing the fastest. Given that the most expensive varieties are also those with the highest quality, country specialization is thus occurring not on the basis of sector or exported goods, but on the basis of product quality. For example, the emergence of China as a major textile producer did not lead to the disappearance of the textile industry in developed countries. Instead, these countries focused on producing high quality textile goods.

If prices are indicators of the quality of goods produced by a company or a country, they nonetheless remain an imperfect measure. Many other factors, including labor and intermediate consumption costs and company productivity, play a role in determining the price of goods. Yet the impact of price increases on demand seems to vary greatly depending on whether this increase is due to rising costs (where quality remains stationary) or rising quality. In the former case, demand should decrease noticeably. In the latter case, the impact of higher prices on demand will be lesser, even neutral. Indeed, economic theory suggests that consumers buy goods and services offering them better value for their money in greater quantities. Thus consumers are, up to a point, prepared to pay more for higher quality goods; consequently, price increases do not necessarily result in lower demand if they can be justified on the basis of improved quality. This is the intuition that led Khandelwal (2010) to find a more accurate way of measuring quality than price alone. Using data on American imports, he is able to determine, for any given product, the price elasticity of demand—that is, the average variation in the demand for a good when its price changes. Thanks to this measure, it is possible to predict the quantity of a good that countries will export to the United States given the price of its products. The gap between the quantity that is in fact sold and the predicted quantity is a measure of quality, the countries in which the gap is greater being those that produce the highest quality varieties.

This indicator of quality is, more generally, an indicator of non-price competitiveness, as it measures a country's or a company's ability to sell more than its prices would lead one to expect. This capacity may be tied to the inherent quality of its products, but also to their originality, image, and reputation. Thus increasing the competitiveness of a country's businesses does not necessarily require a race to the bottom in terms of price, but, rather, increased quality in the eye of the consumer.

The Implications of Increased Specialization on High-End Varieties

Multiple factors determine quality and non-price competitiveness. Several recent works suggest that one such factor is competition on national and international markets.

Amiti and Khandelwal (2013), for example, show that increased competition on the domestic market leads to an increase in the quality of the goods produced in this country, providing that

their starting level was sufficiently high³. Martin and Méjean (2014) specifically analyze the impact of competition with low-wage countries on French companies. They show that such competition results, for any given product, in a reallocation of market share from companies producing lesser quality goods to companies producing higher quality goods. Piveteau and Smagghue (2013) show that the competition of lower-wage countries does not only lead to a reallocation of market shares, but also pushes French companies to increase their quality.

In this way, faced with pressing competition from low-wage countries, more developed countries try to avoid direct competition with these countries by positioning themselves in high-end markets and improving their non-price competitiveness. What, for these countries, are the consequences of these developments?

First, they affect labor markets. The production of better quality goods requires a correspondingly larger number of skilled workers than are needed to produce lesser quality goods. Increased specialization in high-end varieties thus tends to increase the demand for skilled as opposed to non-skilled labor. In the short term, during the time needed for the supply of skilled workers to adjust (through training, for instance), this heightened demand for qualified workers leads to greater income inequality. Verhoogen (2008) shows this in the case of Mexico. The peso crisis of the mid-1990s stimulated Mexican exports. Since the United States was Mexico's primary trade partner, companies adapted by improving production quality. American consumers expect higher quality than Mexicans. At the same time, greater income inequality between skilled and unskilled workers was observed.

Specialization by quality levels impacts, moreover, the growth and volatility of a country's exports. Martin and Mayneris (2013) have developed an original method for identifying high-end French exporters. As a benchmark, they use the companies belonging to the Colbert Committee, an association representing the interests of France's luxury industry. Using customs data, they define high-end exporters as French companies selling the same products as the Colbert Committee's companies⁴, at at least the same price levels. In this way, they show that high quality is not the sole preserve of large companies producing and exporting large quantities of goods to many different countries. Many high-end producers are niche producers that export only one or two products to one or two countries. They tend, however, to export more, primarily to countries that are, on average, further away. Thus high-end exports are geographically more diverse: 50% go to Europe, compared to 75% for average and low-end goods. Furthermore, high-end companies are better able to redirect their exports when opportunities arise. These are the countries which, over the past fifteen years, increased their sales in Asia (not including Japan). Martin and Mayneris (2013) show that these exports' distinctive geographic distribution can be entirely explained by the fact that high-end companies are less sensitive to distance: since distance is not (or is less of) a drag for these companies, they are better able than others to conquer promising markets. Yet their sales, however, are more sensitive to income variations and are thus more volatile on any given market. But here, too, the fact that they are less sensitive to distance makes high-end exporters rather flexible: by allowing their sales to be more

³ For countries in which production quality is initially low, increased competition does not function as an incentive in the same way, as these countries are too behind in terms of quality to become genuinely competitive on this front.

⁴ This organization includes more than 70 members, including such well-known names as Christian Dior, Chanel, Champagne Bollinger, and Van Clef & Arpels.

geographically diversified towards countries with less synchronized economic cycles, lesser sensitivity to distance allows them to greater diversity their risks. Ultimately, high-end exporters' aggregate sales on international markets were just as volatile, between 2006 and 2008, as the sale of middle or low-end goods.

Thus because high-end exporters are less sensitive to distance, increased non-price competitiveness allows a country to take better advantage of opportunities on international markets and to better diversify the risks and shocks of demand that companies face.

Increasing Non-Price Competitiveness, Investment and Cost Competitiveness

For companies, making products more non-price competitive requires investment. Iacovone and Javorcik (2012) show that one year before a Mexican company began exporting a particular variety to the United States, its price on the domestic market increased. At the same, companies preparing to export new varieties invest more than others. For Mexican companies, conquering the American market means adapting to American consumers' tastes and thus improving their products' intrinsic quality as well as their image. To do so, they must invest by improving the quality of their raw materials, increasing quality control, packaging, advertising, and so on. COE-Rexecode's surveys of European consumers, which is cited by Fontagné and Gaulier (2009), show that while French companies had name recognition, consumers preferred the technological innovativeness of German over French products by significant margins.

A company's capacity for investment is, however, heavily conditioned by its profit margins. It is by attaining adequate profit margins that companies acquire the funds required to make investments or raise the funds needed to do so. Non-cost competitiveness and cost competitiveness are, in this way, directly connected.

Conclusion

A recent study by the French national statistics agency (INSEE)⁵ suggests that over the past fifteen years, the investment rate has been somewhat higher in France than among its European neighbors, when one corrects for cyclical variations. Even as their profit margins contracted, French companies did in fact continue to invest, due to a decreases in capital access costs. This investment tends, however, to be replacement capital investment rather than new product investment. Consequently, it contributes less to increasing the non-price competitiveness of French products. The tax cuts provided for by the Responsibility Pact⁶ should improve the price competitiveness of French companies and allow them to return to greater profit margins. The use of these profit margins will thus prove crucial. In the current debate about over what businesses should do in exchange for the benefits they will receive from the Responsibility Pact, the state must ensure that tax decreases lead to the investments that are needed to restore the non-cost competitiveness of French companies rather than to higher profits or salaries, even if this means increasing taxes on non-reinvested profits. In the medium term, ensuring that companies use tax

⁵ Eudeline J.F., Y. Gorin, G. Skénard et A. Zakhartchouk, 2013, "En France, l'investissement des entreprises repartira-t-il en 2014 ?," occasional note.

⁶ The "pacte de responsabilité et de solidarité" or Responsibility and Solidarity Pact was an initiative launched in late 2013 by French President François Hollande, and which has since been partially implemented. The basic principle is that, in exchange for lighter taxation and regulation, French companies will create more jobs.

cuts to make more investments is more urgent than ensuring that these tax cuts result in more jobs.

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